Getting to grips with trusts

In the first of a series of articles, we look at the types of trusts and where they can be useful.

Trusts provide a way of giving away assets but giving them to trustees to look after on behalf of the beneficiaries, rather than directly to the beneficiaries themselves.

The person creating the trust and providing the assets is the settlor. The trustees – individuals or a trust company – become the legal owners of the assets and look after them, based on the terms of the trust deed and trust law.

The beneficiaries benefit from the trust assets, either by right or at the trustees' discretion, and from the income the trust produces, the trust capital or both.

When are trusts useful?

Historically, trusts have been created for asset protection – either to protect a potentially spendthrift beneficiary from themselves, or to look after the funds for those incapable of doing so because of age or medical reasons.

For example, rather than put a large sum into a bank for a child to spend on whatever they like at 18, funds can be put into trust instead and held to a time when the trustees are happy the beneficiary can manage the funds.

Trusts can also help with estate planning. As an example, grandparents might want to pay for their grandchildren's school fees. One option is to put funds into trust for their grandchildren now, which means for inheritance tax (IHT) purposes the gift is today, but the trustees then use the funds over the following years for school fees. The grandparents have made a substantial early gift, which is ignored for IHT purposes after seven years, rather than a series of ongoing gifts which each have a seven-year gift period.

Trusts can also be helpful on death – rather than having to choose who to leave a large estate to, the assets can be put into a trust, providing flexibility as to who benefits and when, without adding to anyone's personal IHT estate.

Types of trust

There are now three main types of 'family' trust:

- Immediate post-death interest (IPDI) trusts – created on death, with the beneficiary having a lifetime right to the trust income. The capital is often distributable at the trustees' discretion.

  An IPDI is different from other trusts because, for IHT purposes, the assets are aggregated with the estate of the beneficiary. IHT is charged on their personal assets and the trust assets added together.

  This type of trust can be useful purely as protection for the beneficiary. Where the beneficiary is a surviving spouse, the spouse exemption for IHT applies as if they had been left the asset outright.

- Interest in possession trusts (IIP) – also known as a life interest trust. An IIP also gives a beneficiary a right to the trust income but is created in a lifetime. However, the trust assets are not part of the beneficiary's estate (unless created before March 2006), and the trustees pay their own IHT charges every 10 years.

While the trustees have no discretion over the income of the trust, they generally have discretion to pay out the capital.

- Discretionary trusts – here both the income and capital are payable by the trustees entirely at their discretion, providing the most protection. As with a new IIP trust, the trustees pay their own IHT, so the assets are not chargeable on anyone's death.

Non-family and specialist trusts include employee ownership trusts, pensions, insurance products and IHT planning products like discounted gift trusts – which we'll cover in future Shipshape articles.

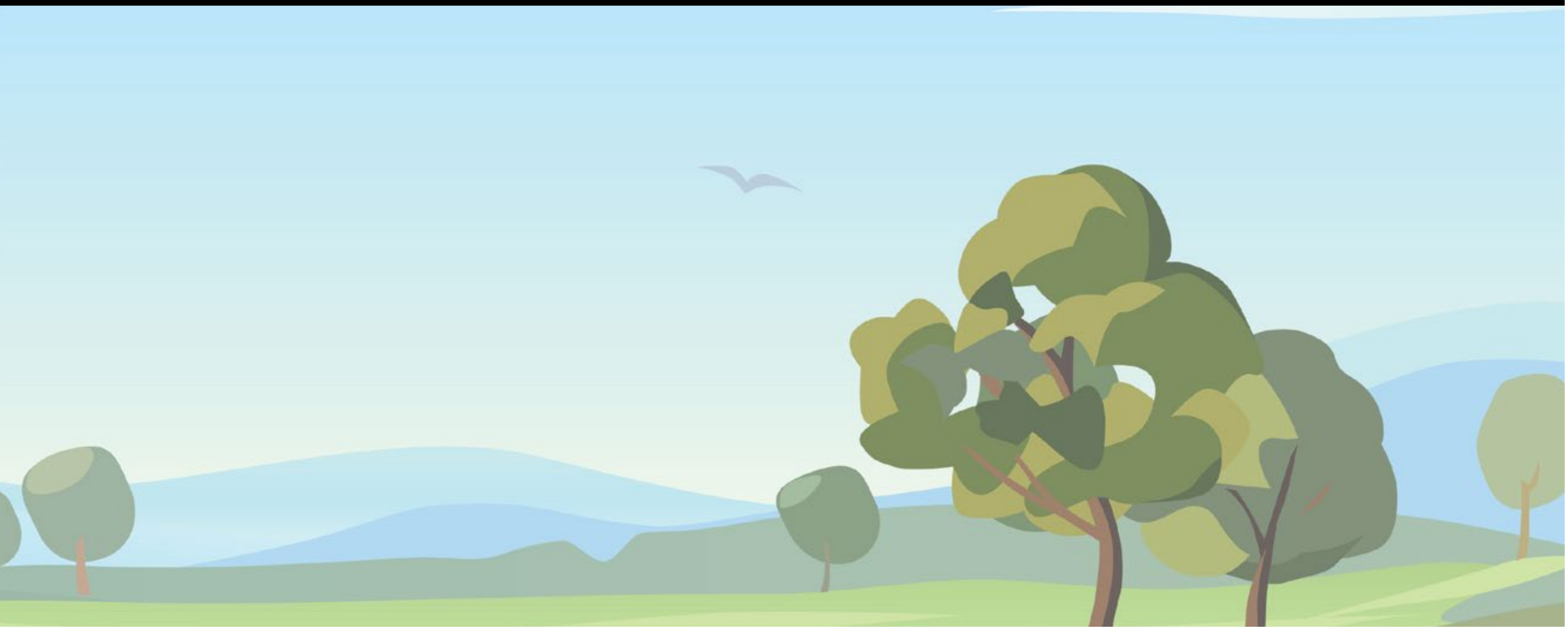
One further non-family trust is a charitable trust. This is another way of setting aside a large amount now, for use in the future either as an ongoing annuity for specific charities, where funds can be released over time or on certain events, or as a family charity legacy for use in the future.

Tax benefits

While a trust's primary use is for asset protection, there are also several tax advantages.

For IHT purposes, creating a trust in lifetime can enable a large gift to be made and earmarked for beneficiaries now, which in turn starts the seven-year clock running. Any gift above the exemptions is a lifetime transfer which is no longer subject to IHT after seven years have passed.

A gift into a trust is an immediately chargeable transfer. This means there is a charge to IHT if the gift into trust is above

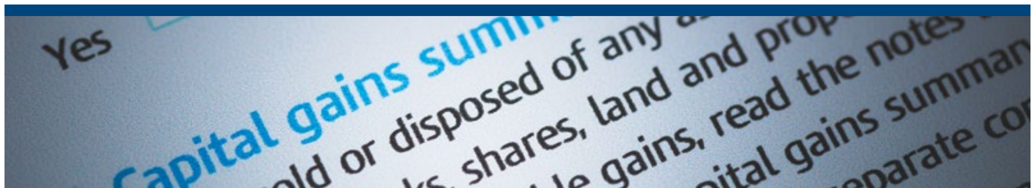


the settlor's available nil rate band of £325,000. This also means that a married couple could settle trusts worth £650,000 every seven years, and over time put aside a sizeable sum that will escape IHT on their death.

A trust does suffer IHT at 6% on the value of the assets above the nil rate band every 10 years. However, it should be noted that with no change in value of the assets, it would take over 60 years for the IHT paid by the trust to be equivalent to the 40% suffered on a death.

Some people are happy to put in more than £650,000, and suffer the 20% initial charge on that gift, but this should be limited to very high-value estates, and those where it is clear the assets will likely rise in value.

It's also worth noting that assets which qualify for IHT relief do not suffer this entry charge. As an example, unquoted company shares which qualify for Business Relief for IHT purposes, can be put into a trust at any value without any initial charges.



We will cover the other tax advantages of trusts in more detail in future Shipshape articles, but in summary:

Income tax – Trusts are generally neutral for income tax purposes. An IIP or IPDI trust pays tax on its income at basic rates, and the beneficiary then reports all the income on their return with a credit for the tax paid by the trust.

A discretionary trust pays income tax at the highest rates, but when a distribution is made it has attached a 45% income tax credit – so if the beneficiary is only a 20% taxpayer, they can recover 25% of the tax. If used for school fees, and the child is a 0% taxpayer, they can recover the whole of the tax within their personal allowance.

Capital gains tax (CGT) – On the creation of a trust, provided it is not 'settlor interested', any gains on assets added to the trust can be 'held over'. No gain arises here and the trustees take the asset at the same base cost as the settlor. Therefore, cash is not required to settle a trust, and it can be beneficial to settle shares or property into a trust under holdover so no CGT arises here, although it is passed on to the trustees in the future. However, as with IHT, this does enable a gift to be made without incurring a significant upfront tax charge into a protected environment. Trustees pay CGT in the same way as individuals, but at the highest rates, currently 20% and 28%.

The rates above are as they stand today – we await the detail on the Health and Social Care Levy, and whether the additional 1.25% tax on dividends will affect trusts as well as individuals, but it is expected that it will.

How we can help

Trusts come with set-up costs and ongoing work to prepare accounts and annual tax returns, but can be a very powerful and beneficial tool – if used correctly.

At Shipleys, we can provide trust and estate planning advice, arrange for a trust to be created and provide ongoing guidance. For will trusts, we can arrange a suitably worded will to be drawn up to create a trust on death and provide probate services and trust services. More details on trusts and estates from the Shipleys website at: *https://tinyurl.com/uc3496wt*