



WHY MAKE A TRUST?

England & Wales

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STEP 
ADVISING FAMILIES ACROSS GENERATIONS

WHAT IS A TRUST?

Trusts have been used by families for centuries.

A trust is the formal transfer of assets (it might be property, shares or just cash) to a small group of people (usually two or three) or to a trust company with instructions that they hold the assets for the benefit of others. If the trust is to be made in your lifetime, to take immediate effect, then it is usually evidenced by a trust deed. If it is to be created on or shortly after your death, then the trust provisions must be set out in your will – a ‘Will Trust’. Whether by lifetime settlement or by will, the trust document states who are responsible for looking after the gifted assets (the trustees), who are to benefit (the beneficiaries) and any rules or conditions to which the trustees and beneficiaries must adhere.

Additionally it must specify clearly the initial trust property, sometimes called the ‘trust fund’. The separation of the legal ownership and beneficial ownership is the unique characteristic of the trust concept; trustees are the legal owners but the beneficial owners are the beneficiaries, and the trustees owe duties to the beneficiaries; in particular a duty of loyalty and a duty to put the beneficiaries’ interests first, above their own.

A trust should last for as long as you think appropriate, but you must stipulate the trust period in the trust document. It might be for just a few years, perhaps during a person’s widowhood or until a child attains a certain age or marries. However, trusts can last for much longer – up to 125 years – or forever if it is a charity. It is usually advisable to give the trustees the power to terminate the trust at their discretion.

If you are creating the settlement in your lifetime then you can appoint yourself and your spouse/Civil Partner/partner as trustees, if you wish, so that you retain some control over the assets and the decision making power, though you must exercise this for the benefit of the beneficiaries.

Problem:

Parents, grandparents and others have always been concerned that children and grandchildren are at risk if they receive or inherit too much too soon.

Solution:

Create a trust to hold the assets until the children are older and wiser.

WHY MAKE A TRUST?

Throughout their history, trusts have provided people with a means of protecting their assets and controlling how they are used after they have been given away. When a person makes an outright gift to someone, either during their lifetime or on death in their will, the new owner assumes all rights over the property and may deal with it as they wish. The creation of a trust will enable the person who is making the gift (called the settlor) to attach certain conditions to it. They can give away their property, but 'with strings attached'. For almost 1,000 years, families have been using trusts to preserve and manage their wealth for the benefit of their heirs.

Control

When a settlor puts assets into a trust, they set out in the trust document how those assets are to be dealt with. They will be able to say who will benefit and to what extent; whether the property may be sold or used for certain purposes and who will benefit from it in the future. The day-to-day management of the trust property is the responsibility of the trustees, but the settlor (if they are alive) may also be a trustee. Settlers can therefore, both remotely by the terms included, and directly as trustee, manage property that they no longer own – provided that their decisions are made in the interests of the beneficiaries and in accordance with the terms of the trust.

Protection

Perhaps you would like to give away some of your wealth to benefit other members of the family, but you are concerned that it will be dissipated. A trust can restrict the amount and type of benefit received from the property. For example, you may wish to assist your niece with her university expenses, but you do not want her to spend the money on a fast car. A trust is the ideal vehicle to achieve this end.

Flexibility

A trust can allow your trustees to adapt to circumstances as they arise. If you make an outright gift of property, you cannot change your mind and give it to someone else. Suppose you have two adult children: one is in highly paid employment and the other is still studying. With a trust that is flexibly drafted, the income from say, a rental property could be used by the trustees to benefit the child with a low income. If in later years, if the highly paid child takes a career break to raise a family, whereas the other child is earning a good salary, the trust income could then be used to help with the costs of raising your grandchildren.

TRUST TYPES

Trusts fall broadly into two main categories according to how the income or benefit (dividends, interest, rents, free use of property, etc.) is dealt with:

- *Interest-in-possession trusts*: those where the income or benefit must be given to the specific beneficiary – it is his or hers by right. There may be more than one beneficiary but they will all have a fixed entitlement.
- *Discretionary type trusts*: benefits are allocated at the trustees' discretion to any one or more of several beneficiaries. The trustees might even decide, for a time, to benefit no one; the income being accumulated for future use.

Let us consider these in more detail.

Interest-in-possession trusts

The interest-in-possession trust (sometimes called a 'fixed interest' or a 'life-interest' trust) is often used in a will when a person dies leaving a surviving spouse, e.g. 'income to my wife for her life and after her death capital to my children'. This sort of trust is popular in the wills of people marrying for the second time, each having children by their first marriage. It ensures that the spouse is provided for, but the children of the first marriage do not see their parents' wealth passing to the children of the surviving step-parent.

You might leave your estate to your spouse, in part as an absolute legacy and the remainder in trust for life. You can give the trustees wide powers to use their discretion over the capital to help in case of need, including the power to make capital advances or interest-free loans to your widow(er) or children. You may want to give shares of the family company to your children or grandchildren but fear that they might sell or gift them outside the family. To avoid this, the shares could be held in trust for, say, 'my children equally for their respective lives and thereafter for my grandchildren who survive'. By this means, the children and grandchildren benefit from the income from the shareholding, but cannot control the voting power of the shares nor dispose of them – only the trustees can do that.

Discretionary trusts

Discretionary trusts give the trustees power to make gifts of capital and/or income to a stated class of potential beneficiaries. Such a trust may suit you if you have identified a particular group of people you want to benefit but you are unsure which of them, in the future, will need help or in what proportions. For example, as a grandparent you might like to set aside capital for your grandchildren – including those who may be born later, even after your death.

Alternatively, you might wish to benefit your children but are aware that some of them are already wealthy and may not wish to be made wealthier by your intended gift. A discretionary trust in favour of all your children and grandchildren would allow the trustees to take into account the changing needs and resources of both your children and your grandchildren so that they would have the flexibility to benefit your grandchildren rather than your children if that was appropriate in the circumstances.

Capital advances and the income arising from the trust property are distributed entirely at the trustees' discretion – no one has an 'interest-in-possession' as described above.

Problem:

You may feel that, by giving in your will all your wealth to your spouse/partner absolutely, it may be spent or invested unwisely, so that little or nothing will remain for your children to enjoy.

Solution:

A will trust for your surviving spouse can ensure that the capital is protected, but without loss of benefit during widow(er)hood.

You may also create a discretionary trust where the trustees' discretion is limited to a certain extent. For example, they may have the power to decide whether to distribute income or accumulate it; or they may have power to decide how to share out the income; but they are not allowed to change the beneficiaries' shares in the capital. All the rules of the trust: how the property is to be used and the powers of the trustees, are set out in the trust document. The trust can be tailored to suit your aims. It is of course important that the deed or will is drafted by a suitably qualified professional who will know how to achieve the desired outcome.

The most favourable characteristic of the discretionary trust is its flexibility. An English discretionary trust can last for up to 125 years and income can be accumulated throughout the lifetime of the trust if desired. Even the class of beneficiaries can be enlarged by giving the trustees the power to introduce new beneficiaries as the need arises.

You might wish to make a lifetime settlement for the benefit of just your children and grandchildren but be worried that, if you died, your widow(er) might be in further need of capital or income; the trust funds would not then be available to help. To deal with this situation you could include as a beneficiary 'my widow(er)' so that when (and only when) you die, your spouse joins the beneficial class and the capital and income becomes available for his/her use if required. Your elderly parent or other dependant could be helped with this type of trust. On the subsequent death of that person, the trust would continue for the benefit of other class members.

Discretionary will trusts

Just as a discretionary trust can be created to commence in your lifetime, it can also be a feature of your will, becoming effective only on your death.

You might give a portion of your estate to a separate discretionary trust for the benefit of, say, all your grandchildren. Alternatively you might prefer that your executors decide how the whole of your estate is to be dealt with in the light of the tax and domestic circumstances existing at the time of your death.

Before October 2007, it was common to include a nil-rate band discretionary trust in the wills of married couples and Civil Partners. Its purpose was to save inheritance tax by making use of the nil-rate band of the first to die. The Finance Act 2008 changed the law to enable the unused part of the nil-rate band to pass to the surviving spouse/Civil Partner, so that this tax saving arrangement was no longer required. If you made your will before this change in the law, you need to take advice on whether your current will remains appropriate to your wishes and requirements.

Charitable trusts

You may be inclined to make regular donations to charity or you may have a particular interest in some worthy cause. Rather than make regular payments out of income or a legacy to a national charity over which you have no control, you could create your own charity either in your lifetime or on your death by creating a charitable trust in your will. Gifts to such a trust are free of capital gains tax and inheritance tax. The income arising will not generally be assessed to tax. Of course, the trust can only be used for charitable objects, i.e. the relief of poverty, the advancement of religion, education or the public good. Charitable trusts can last forever – a truly lasting memorial.

Vulnerable person trusts

It is possible to set up special trusts for the benefit of disabled beneficiaries. Although these can be discretionary or interest-in-possession trusts, during the lifetime of the disabled beneficiary, special tax rules apply so that it is possible for the trust assets, income and gains to be taxed as if the beneficiary owned them.

Problem:

You might currently have an aged dependant – a widowed mother perhaps or retired housekeeper – who would need continuing care should you die before her.

Solution:

A trust can be created to hold sufficient capital to continue the help. On their death the funds can return to you or pass to your family.

TRUSTS AND TAXATION

Tax consequences may influence the type and timing of the trust you choose. An advantage for one tax may create a disadvantage for another. For example, you may save inheritance tax by the creation of a trust, but incur a higher rate of income tax on the trust property. Or you may save capital gains tax by paying inheritance tax.

As a general rule with regards to tax efficiency, you, as settlor, and during your lifetime, your spouse/Civil Partner, must be excluded from all benefit, otherwise the capital will still be regarded as yours for most tax purposes as if you had never created the trust. This rule does not apply if the trust is created in your will – as you will be dead by the time the trust comes into force.

Inheritance tax

In your lifetime you can create a trust into which you can place chosen assets that you no longer need yourself. This reduces your own wealth and thus your exposure to inheritance tax on your death. There is a charge to inheritance tax when a lifetime trust is created but at a lower rate of tax than is paid on death. No inheritance tax is charged where the cumulative value of the assets placed into the trust together with any gifts within the preceding seven years is within the nil-rate band (currently GBP325,000). Thus there is the opportunity of making tax-free gifts within the nil-rate band over a period of time in order to reduce your taxable estate on death.

Once a trust is created, whether in lifetime or on death, inheritance tax is applied to the property according to the type of trust. Most trusts created during lifetime (other than trusts for the disabled and bare trusts) as well as discretionary trusts created by will are subject to a special trust regime that imposes inheritance tax charges when property leaves the trust and on each ten-year anniversary. Interest-in-possession trusts created by will and trusts for the disabled are subject to a different regime and the trust assets are subject to inheritance tax as if the beneficiary owned them.

Capital gains tax

Capital gains tax is charged on disposals of assets and on gifts – both between individuals, and when property passes into and out of a trust. Where the gift is to a trust, however, the tax may often be postponed, resulting in a more favourable outcome than an outright gift to an individual. The rate of capital gains tax and annual exemptions are generally less favourable for trusts than for individuals.

Income tax

Discretionary trusts are taxed at a higher trust rate of income tax, whereas interest-in-possession trusts are taxed at standard rates. The trust rate of income tax is a significant disadvantage where income is to be accumulated. However, there are provisions for the beneficiaries to claim a refund of the additional tax where the income is distributed to them.

Where a settlor creates a trust for the benefit of himself, his spouse or minor children, the income will be taxed as if it belonged to him, regardless of who receives the income. If the settlor and spouse/Civil Partner are excluded, the settlor may still be taxed if his or his spouse's /Civil Partner's minor child receives a benefit.



MATCHING A TRUST TO YOUR NEEDS

Whether creating the trust by will, or in your lifetime, selecting the trust type and its terms are very important. In this leaflet we have mentioned only the main types of trust; there are many variations – the protective trust, which automatically terminates the interest of a profligate beneficiary who attempts to dispose of their interest; the (once popular) marriage settlement; and the ‘bare’ trust, which makes the beneficiary the actual owner, to name a few. Whatever the situation, a trust can be constructed to suit the need.

For maximum flexibility it is usual to give the trustees wide management powers so that they are better able to respond to any changes in family matters, taxation or government policy. With such wide trustee powers be sure to choose your trustees carefully. A trust that might last for 125 years needs careful planning, so you should take specialist advice beforehand.

Problem:

Your son or daughter might be in danger of bankruptcy; in an unstable marriage or other relationship; be disabled and in need of special care; or for some other reason be incapable of managing their own financial affairs.

Solution:

In any of these situations cash, shares, property or other forms of wealth can be placed into a suitable family trust carefully worded to take account of the perceived risks surrounding the intended beneficiary.

Can a settlor be a trustee?

Yes

Can a trustee be a beneficiary?

Yes

Can I be a sole trustee?

Technically yes (unless the trust holds land), but it is not preferred.

How many trustees should there be?

Two or three are preferred. Four is the maximum (unless it is a charity) and only one trust corporation is needed.

Must I appoint a professional trustee?

No, but be extra careful to whom you give the power and responsibility of trusteeship.

Can a trust protect assets from divorce or bankruptcy proceedings?

The matrimonial courts have wide powers so protection is only available up to a point. Much depends on the terms of the trust, the timing, the purpose for which it was created and the way it has been administered.

Can I put assets into a trust but keep the income from (or use of) the assets myself?

The tax consequences of this are usually unacceptable as income would be taxed as yours. On your death, the value of the trust assets would be added to your own estate and inheritance tax charged on the total. In certain limited circumstances, however, it might be appropriate, particularly if tax is not an issue, e.g. self-settled disabled trusts.

My chosen executor/trustees for my modest estate are relatives — but laymen. Is this wise?

If they are an adult and sensible this should not cause a problem. They will have the power to hire (and fire) professionals who would (or should) be able to advise them what to do.

WHAT IS STEP?

STEP is the worldwide professional association for those advising families across generations. We help people understand the issues families face in this area and promote best practice, professional integrity and education to our members.

Today we have more than 20,000 members across 95 countries from a range of professions, including lawyers, accountants and other specialists. What connects our members is that they all help families plan for their futures: from drafting a will or advising family businesses, to helping international families and protecting vulnerable family members.

This leaflet and the companion leaflets 'Why make a will?', 'What to do when someone dies' and 'Why make a Lasting Power of Attorney?', as well as other informational leaflets produced by STEP, are available to view and order at www.step.org/leaflets

This leaflet was updated in January 2015 and applies to England and Wales only. Different laws apply in other countries, including in Scotland and Northern Ireland.

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in your area, contact the STEP office or visit
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