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Types of Trusts

The Finance Act 2006 introduced extensive changes to the Inheritance Tax treatment of trusts, meaning that many of the differences between the taxation of different types of trusts have now disappeared. There are some transitional provisions for trusts in existence at that time. Individuals who are involved with any kind of trust should review the existing arrangements to ensure they remain in keeping with the aims of the trust.

The consequence for lifetime Inheritance Tax planning (by means of gifting assets into trust) is that planning will need to be taken much earlier on in life, perhaps by use of the nil rate band every 7 years. The thinking behind trust asset planning may change from thinking ahead one generation to thinking longer term for generations down the line. Nil rate band will trusts set up on an interest in possession basis will continue to be treated as before, but for one generation only. Again, a review of existing arrangements is advisable.

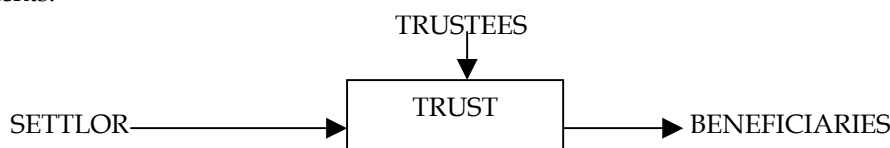
Please note that the below is intended as a broad guide only to a relatively complex area. Please see our separate Research Note on the Taxation of Trusts for fuller details of the taxation treatment to be taken into account when choosing the most suitable type of trust for your needs.

If you would like to discuss any of the below, or to arrange a meeting with a clarityLAW adviser, please contact your usual adviser, or clarity on:

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What is a Trust?

A trust is a relationship created when a **settlor** transfers property to a **trustee** directing him to account for the benefit of that property according to the **trust deed**, normally to **beneficiaries** designated by the settlor. Trusts (other than bare trusts, where the beneficiary cannot be changed), are often also known as settlements.



The concept of trust is based on two types of interest in property. Whenever the equitable interest and legal titles in a piece of property do not belong to the same person there will be a trust:

- The common law or legal title belongs to the person whose name is on the title deeds to land or the share certificate of a company (the **trustee**). This individual is the person who will affect any necessary formalities – for example they will sign the documents to transfer the property to a purchaser.
- The equitable or beneficial title belongs to the person who is entitled to derive the real benefit from the property (the **beneficiary**).

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Overseas Property

It should be noted that the concept of a trust is a common law concept and therefore not universally recognised. Some countries, notably France and Spain, are civil law jurisdictions and do not recognise trusts. Care is therefore needed where property located in a civil law jurisdiction is subject to trust as the concept will not be recognised on death of the settlor or beneficiary and property may not pass in accordance with any trust documentation. Furthermore, property located in these jurisdictions may be governed by “forced heirship” rules with a certain percentage passing to defined beneficiaries irrespective of the wishes of the deceased.

How is a Trust Created?

Trusts can be established either:

- during the settlor’s lifetime (a ‘lifetime’ settlement), or
- shortly after someone’s death.

Trusts that are made during the lifetime of the settlor and take effect immediately are established by a trust deed and tend to be known as ‘Settlements’.

Trusts which are created by a Will and come into operation on the death of the person having made the Will are known as ‘Will trusts’.

The Settlement (or Will) states:

- whom the trustees and beneficiaries are;
- lays down the terms of the trustees’ appointment;
- the period of the trust; and
- contains all the other terms of the trust.

How long a trust lasts is up to the settlor, but must be stated. It could be for the duration of a person’s lifetime or until a child attains a certain age or marries. Trusts can, however, last up to a maximum of 80 years (a charitable trust can in fact last forever). A commonly asked question is that if you, as settlor, are creating the settlement in your lifetime, can you appoint yourself or your spouse as trustee? The answer is yes.

Why Make a Trust?

There are two main reasons for creating trusts:

- taxation
- personal/domestic reasons

Taxation

You can create a trust during your lifetime into which you place assets you no longer need. This will reduce your own wealth and can mitigate your own liability to inheritance tax on your death. You could create a trust for your grandchildren in your lifetime or after your death. Skipping a generation in this way can reduce your own children’s exposure to tax. Please see our separate Research Note on the Taxation of Trusts for fuller details.

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Personal/Domestic Reasons

Whilst trusts have been used by some as vehicles for tax avoidance, the majority of trusts have been used to cater for family circumstances. For example, parents and grandparents may be concerned that children and grandchildren are at risk if they receive or inherit too much too soon. A trust can be created to hold assets until the children are older, wiser and more experienced in dealing with money.

Alternatively, you may be concerned that if you leave all of your estate to your spouse, he or she may in turn leave insufficient capital to your children. A simple solution would be for a Will trust to be established for the surviving spouse, thus ensuring that the capital is protected without loss of financial security during the surviving spouse's lifetime.

You might have an aged dependent who needs continuing care should you die before them. A trust can be created to hold sufficient capital to continue with that help and, on their subsequent death, the funds pass to your children.

Your son or daughter (or indeed their spouses) might risk bankruptcy, an unstable marriage or other unsuitable relationship, be handicapped and in need of special care, or for some other reason be incapable of managing their own financial affairs. In any of these situations, assets can be placed in a suitable trust vehicle carefully worded to take account of the perceived risks surrounding the intended beneficiary.

Types of Trust

The Finance Act 2006 made extensive changes to the way trusts are taxed in relation to inheritance tax. As a result of this, many of the differences between the taxation of different types of trust have gone. However, there is a distinction now between how trusts are treated for inheritance tax purposes, depending on whether they are a lifetime settlement or created on death – see the taxation section below for more details.

When looked at from the perspective of what the trust achieves, rather than the tax treatment thereof, there are in essence two types of trust:

- Those in which beneficiaries have a vested interest.
- Those in which beneficiaries have only a prospective interest ('non vested').

Each of the two types can be further sub-categorised into those created during the settlor's lifetime, and those created on death.

Vested Interest - Lifetime Trust

These trusts are generally known as **Interest in Possession Trusts (IIP)**. An IIP trust is a trust under which a beneficiary has a right to receive the income from the trust as and when it arises, or a right to the enjoyment of trust assets, e.g. living in trust property. An IIP can take ostensibly three forms:

1. Life Interest Trust

This is a trust where one person, the 'life tenant', has a right to income for life or for a fixed period, and others, the 'remaindermen', are entitled to the capital on the death of the life tenant or on the expiry of the trust period. An IIP trust can be made more flexible if the settlor requires, by giving trustees power to

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give capital to the life tenant or, in very flexible versions, giving them power to override the life tenant's life interest and pass capital to another class of beneficiary who may not be the remaindermen.

2. Flexible (or 'Power of Appointment') Trust

This is a form of IIP trust under which the trustees have a power to appoint either income or capital amongst beneficiaries. They also have the power to vary the beneficiaries. There are usually two classes of beneficiary, actual and potential. The trustees have the power to replace an actual beneficiary by anyone from the list of potential beneficiaries.

3. Bare Trust

This is a trust where the beneficiary has an immediate and absolute right to both capital and income which cannot be taken away. The trust can have more than one beneficiary provided that their shares are specified.

A bare trust would be created if an outright gift were made to a child in a Will. In view of the child's inability to effect a valid contract, the executors named in the Will act as trustees until such time as the child reaches the age of 18. When the child reaches the age of 18 he or she can demand that the assets held in trust are transferred into their own name as absolute owner.

Vested Interest - Trusts Established on Death (Will Trusts)

1. Immediate Post-Death Interest Trust

This is a type of interest in possession (IIP) trust, established on death (by Will or Intestacy). Unlike an IIP established in the settlor's lifetime, this is not treated as a relevant property trust. This means that there are no additional inheritance tax implications for passing the assets into trust initially, however, the life tenant is deemed to own the trust assets, and on their death the trust assets are aggregated with their own estate, on which IHT will be payable if the combined assets exceed the nil rate band applicable at the date of the death of the life tenant. Any inheritance tax due will be proportioned between the trust and the estate.

At the date the trust is established, if the life tenant is the surviving spouse then the IHT spouse exemption applies. Immediate post-death interests with the surviving spouse as the life tenant are a very popular form of trust. It ensures the protection of family assets whilst at the same time ensuring the spouse exemption for IHT purposes and the financial provision of the spouse.

2. Bereaved Minors Trust

A bereaved minors trust is a trust that must be created by a Will or an intestacy for the deceased's own child. On attaining the age of 18 the minor must become entitled to the trust property and any income arising from it. Whilst the bereaved minor is living and under the age of 18 the capital must be applied for his/her benefit and he/she must be entitled to all of the income from the property.

3. 18 to 25 Trust

These are sometimes known as trusts for 'bereaved young people'. As a result of the public criticism of the very restricted trusts afforded privileged treatment for IHT, the Finance Act 2006 was amended and this new form of trust was created. This allows entitlement to capital to be deferred beyond 18. However, the IHT privileges are restricted.

As with a Bereaved Minors Trust, a Will must create the trust for the deceased's own child and that child become entitled to the assets and any accumulated income at or before the age of 25. Whilst the child is

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under the age of 18 the relevant property regime will not apply. However, there will be an exit charge if the beneficiary becomes entitled to capital after the age of 18. This is a complicated charge but will not be greater than 4.2% of the sum in excess of the trust's nil-rate band.

Non-Vested Trusts - Created in Lifetime or on Death

1. Discretionary Trust

Here the trustees have the discretion as to how to pay the income between a number of income beneficiaries. Alternatively the trust deed may allow the trustees, instead of paying out income, to accumulate that income. Such power of accumulation can only be given within a particular period of time, e.g. 21 years from the date of the trust deed (or on the death of the person creating the trust within the Will). Accumulations of income are added to capital, although the trust deed may allow past accumulations to be paid out as income of the current year.

The trustees also have the power to appoint capital to the beneficiaries in whatever proportion and to whomever they decide. These trusts are extremely flexible.

2. Accumulation and Maintenance Trust

An accumulation and maintenance trust (an 'A&M trust') is a form of discretionary trust which, prior to 22 March 2006, enjoyed favourable IHT treatment - subject to complying with certain conditions. The favourable tax treatment, which was not available to other forms of discretionary trusts, was withdrawn from 22 March 2006 (and the transitional period has now lapsed). No new A&M settlements can be created.

Some other types of trusts - not being relevant property trusts:

1. Charitable Trust

Income and capital must be applied exclusively for 'charitable purposes'. Charitable trusts will normally continue in perpetuity, that is, it is not required to come to an end after any particular time.

2. Trusts for the Vulnerable

Special tax provisions have applied as from 6 April 2004 to any type of trust whose beneficiaries are disabled or 'relevant minors' (such trusts being referred to collectively as 'trusts for the vulnerable').

The trustees of such trusts can elect jointly with the beneficiary for the trust to be taxed on the basis of the individual's circumstances for both income tax and capital gains tax, which means that the benefit of the personal allowance and starting rate and basic rate income tax bands of the beneficiary will not be lost. There are qualifying conditions for this special treatment.

3. Statutory Trusts

A trust that is created by statute is called a 'statutory trust'. Such trusts can be unintended and may be tax-inefficient, for example those created when an individual dies without making a valid Will (dies intestate).

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