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Types of Trusts

The Finance Act 2006 introduced extensive and surprising 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 existing trusts. Individuals who are involved with any kind of trust (including provisions for a will 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. Additional rules apply to settlor interested trusts (from April 2006, this includes trusts set up in the settlor's lifetime, where the settlor's minor unmarried children can benefit).

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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<u>What is a Trust?</u>

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.

TRUSTEES ↓

SETTLOR → TRUST → BENEFICIARIES

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**).

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.

Types of Trust

The main types of UK trust that were used up until the Finance Act 2006 changes were:

1. Bare or Absolute Trust

This is not really a trust at all, but rather an arrangement where the beneficiary has an absolute entitlement to the underlying property and the trustee merely holds the property on behalf of the beneficiary, effectively as a nominee. Often bare trusts are used where ownership of shares or units in a unit trust are held by an adult on behalf of a minor.

2. Interest in Possession Trust

This is a trust under which one or more beneficiaries are entitled to income from the trust fund as an absolute right. The trustees have no discretion as to whether or not to distribute income. The income beneficiary is said to have an "**interest in possession**" or is sometimes referred to as the "**life tenant**." Typically the life tenant will have a right to income for a fixed period, usually their lifetime, and then capital will be distributed in accordance with the trust deed to the "**remainderman**" or another interest in possession will commence.

3. Discretionary Trust

A discretionary trust is a flexible trust where no individual beneficiary has a right to the income of the trust. Whether or not they do so is entirely dependent on the discretion of the trustees, hence the selection of the trustees is very important. Discretionary trusts are very flexible as trustees can make distributions to reflect the changing financial circumstances of the beneficiaries.

4. Accumulation and Maintenance (A&M) Trust

An A&M Trust is a discretionary trust (see above) where one or more beneficiaries will become legally entitled to the income, or both capital and income, of the trust on attaining a specified age of not more than 25. A&M trusts are generally used to benefit children or grandchildren of the settlor. Until then, the income can either be accumulated, or it can be used by the trustees for the maintenance, education or benefit of any of the potential beneficiaries. The trust must last in this form for no longer than 25 years, or must be for the benefit of grandchildren of a common grandparent. The favourable tax treatment of this type of trust no longer applies to trusts set up following the Finance Act 2006.

Other Types of Trust:

- **Flexible Power of Appointment Trusts**

These are a hybrid between discretionary and interest in possession trusts. For tax purposes they are treated as interest in possession, as an individual or number of individuals will have an absolute entitlement to trust income. However, trustees also have discretion to appoint or vary beneficiaries and to make appointments of capital to beneficiaries thus giving the trusts the flexibility associated with full discretion. These types of trusts may now be much less popular since the changes in the Finance Act 2006.

- **Offshore Trusts**

Offshore trusts are structured in the same way as onshore trusts and are typically located in centres with established trust expertise, e.g. the Channel Islands. Complex tax rules apply, introduced over many years to counter the wide-scale use of such trusts to avoid tax. However, these are outside of the scope of this summary.