CHAPTER 1

INTRODUCTION TO TRUSTS

1.1 Definitions

The logical starting point is to define exactly what we mean by the term "trust". A widely recognised definition is contained in Halsbury's Laws of Trusts:

> "any disposition of property of whatever nature by any instrument whereby trusts are constituted for the purpose of regulating the enjoyment of the settled property among the persons or classes of persons nominated by the settlor".

The "**settlor**" is the person who **creates** the trust. To create a trust or "settlement", the settlor will transfer assets to the **trustees** who thereafter **hold the property "on trust**". The trustees have a duty to "regulate the enjoyment of the trust property by the nominated persons". Those nominated persons are also called "**beneficiaries**". We shall explore the terms "settlor", "trustees" and "beneficiaries" in more detail later in this chapter.

An alternative definition of a trust can be found at Underhill's Law of Trusts and Trustees:

> "an equitable obligation binding a person who is called a trustee to deal with property which is called the trust property for the benefit of persons who are called beneficiaries".

Once again, under Mr Underhill's definition, a settlor will transfer assets to trustees. At that point, legal ownership of the asset will transfer from the settlor to the trustees.

However, the trustees have an obligation to deal with the property for the benefit of nominated persons called beneficiaries. The beneficiaries will have "beneficial ownership" of the property. This means that only they – and not the trustees themselves – can benefit from the property in the trust.

In essence, wherever there is a **separation of** "**legal title**" **and** "**beneficial ownership**", a trust arrangement will exist. In this relationship, the trustees actually own the assets, but are not allowed to benefit from those assets themselves. Instead the trustees have a duty to use the income and capital of the trust for the benefit of other nominated persons- ie, the beneficiaries. This is why this arrangement is called a "trust" – i.e. the trustees are in a position of trust and have a duty, among other things, to protect and secure the trust property, and to use the assets of the trust as instructed by the trust deed.

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1.2 Parties to a trust

In all trust arrangements, there will be 3 separate parties to the trust.

1. The Settlor

All trusts will have a **settlor**. The settlor is the person who makes the settlement – i.e. the person who transfers the assets to the trustees. The settlor is the benefactor – i.e. the creator of the trust. A "settlement" is simply another word for a "trust". Strictly speaking, the word **settlement has a very wide meaning** and includes certain arrangements which may not formally constitute a trust. However, at this point, we shall assume that the words "trust" and "settlement" are fully interchangeable.

A trust may have more than one settlor – i.e. more than one person can transfer assets to the same trust – but in the majority of instances, a trust will simply have one settlor.

2. The Trustee(s)

When a settlor creates a trust he transfers assets to trustees. On creation of the trust, legal ownership will pass from the settlor to the trustees. **Trustees**, like a company or an individual, are a **separate legal person** and have a legal personality which is separate from the individuals making up the bodies of trustees. As we shall see in forthcoming chapters, trustees – as a legal body – will themselves have income tax, capital gains tax and inheritance tax liabilities.

Generally speaking, any person may act as a trustee as long as they are mentally capable of doing so. The settlor will specify in the trust deed who shall be the trustees of the trust. Most trusts have a minimum of 2 trustees. There is no legal obstacle to a settlor appointing himself as a trustee. Indeed, in many family trusts, the settlor will act as a trustee along with a professional such as the family solicitor. This gives the settlor power to have some say in how the income and capital of the trust should be distributed. For tax purposes, even though an individual may fulfil 2 roles - one a settlor and one as a trustee – it is important to keep these legal persons completely separate.

Within the trust deed, the settlor will often have power to either appoint additional trustees or to remove existing trustees.

3. The Beneficiaries

Within the deed, the settlor will nominate the person or persons who shall be the **beneficiaries** of the trust. In general terms, the beneficiaries are the **only persons who are entitled to use or enjoy the income or assets of the trust.** Trustees may not benefit from the trust, although professional trustees are allowed to receive reasonable remuneration for acting as trustees either under statute or by a provision of the trust deed.

The settlor may <u>not</u> benefit from the trust property, unless he or she is included within the class of beneficiaries. There is nothing to prevent a settlor from being able to benefit from the property he has given to the trustees, although there are anti-avoidance provisions to prevent him from obtaining a tax advantage from doing so.

Remember that even though an individual may fulfil both the role of a settlor and of a beneficiary, we keep these roles separate for tax purposes. It is not altogether unfeasible that an individual could be a settlor, a trustee, <u>and</u> a beneficiary of the trust, although this is unusual.

1.3 Reasons for establishing a trust

There are a variety of reasons why a settlor may wish to create a trust.

(i) Protection for younger beneficiaries

A trust is often a more practical alternative than an outright gift.

Trusts are particularly relevant where the intended beneficiary of the gift is **too young** to be able to manage and control the property. By gifting the assets in the first instance to a trust, the settlor can **retain some degree of control** over the assets he has given away. By using a trust, the settlor can restrict and control the flow of the income and the assets of the trust to the beneficiaries. In such arrangements, the settlor will often play an active role by appointing himself as a trustee.

(ii) Tax advantages

As we shall see during this course, there are some **tax advantages** that can accrue to the settlor on creating a trust. However, the tax advantages of using trusts have been substantially reduced in recent years.

(iii) Guaranteeing succession of property

Very often by gifting assets to a trust, the settlor is **guaranteeing the succession** of the property – i.e. he is making sure that the assets he is giving away remain within his family.

For example, a settlor can create a trust for his wife, and within the trust deed he can stipulate that on his wife's death the assets will pass directly to the children or grandchildren. This arrangement thereby prevents his wife from disposing of the trust property to a non-family member which she would have been able to had the original transfer been an outright gift.

(iv) To conceal beneficial ownership

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An individual may also wish to **conceal the beneficial ownership** of a property, and he can do this by using a trust. A trust could therefore be used to disguise which individuals own shares – and thereby have control - of a company.

(v) To benefit employees / charities

Trusts may also be used to provide **benefits to employees**, or as a means of making **donations to charities.**

1.4 Creating a trust

There are various types of trust, by far the most common being **"express private trusts"**. An "express private trust" is a trust which is expressly created either by a **trust deed** or under a **will**. For example, if a grandfather wishes to transfer assets to a trust for the benefit of his grandchildren, he will create an express private trust either by drafting a trust deed during his lifetime, or directing via his will that assets should be held on trust for his grandchildren.

In order for a trust to be valid and enforceable, certain requirements must be satisfied;

(i) Certainty of words and intention.

This means that the words used in the trust deed must clearly indicate that the settlor wishes the property to be held on trust, and that a **trust is intended**. If there is no absolute certainty of words and intention, there is a danger that the recipient may legally be able to take the property for himself as an outright gift.

(ii) Certainty of subject matter.

This means that the property which is to be held under the terms of the trust must be **clearly identified**, and the interests of the beneficiaries in that property must be ascertainable. In practice, many trusts are originally created with a nominal amount of cash and more substantial trust property – such as shares or land and buildings - is added later.

(iii) *Certainty of objects (beneficiaries).*

The settlor must identify the **persons or classes of persons who the trustees are to regard as the beneficiaries of the trust**. If no beneficiaries can be clearly identified, this test fails and the trust property will be deemed to be held for the settlor or his estate.

Even though the beneficiaries must be clearly ascertainable, they do not need to be individually named within the deed. For example, a trust can be set up for a class of persons such as the grandchildren or great grandchildren of a particular individual. This also means that persons who are not born at the time the trust was created, can thereafter benefit from the trust property. For a trust to be valid, there must be **at least one living beneficiary** at the time the trust is created.

Most trust deeds will give the trustees **power to add new beneficiaries**, although the consent of the settlor is often required. Even though there is no legal obstacle to the settlor or his spouse being a member of the class of beneficiaries, there are tax anti-avoidance rules preventing the settlor from obtaining a tax advantage from doing so. Therefore for tax reasons, it is often **prudent to specifically exclude the settlor or spouse** from being able to benefit from the trust property, and to make this clear within the trust deed.

1.5 Types of express private trusts

It is very important that we are able to distinguish between the two different types of express private trusts.

In very broad terms, a private trust will either be **"discretionary"** or **"non discretionary".** You will often see a non discretionary trust referred to as a **"life interest"** trust or **"interest in possession"** trust.

(a) *Discretionary trusts.*

A discretionary trust is the most **flexible** form of trust, as it enables the trustees to use and **distribute** the income and capital of the trust entirely **at their discretion.** If the trustees of a discretionary trust receive income – for example, rents on a property or dividends on shares etc - they have power to either retain or distribute that income entirely as they see fit.

For example, the trustees could accumulate the whole of the income within the trust, or they could pay out any part of that income to one or more of the class of beneficiaries.

Any trust which has a **power to accumulate income** within the settlement is, broadly speaking, a discretionary trust.

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Discretionary trusts are typically set up by a settlor who wishes the assets to be used to benefit a group of people, but who does not wish to be too prescriptive as to how each individual may precisely benefit. It is therefore common for the settlor to specify a very wide class of beneficiaries such as children, grandchildren and wider family members.

Under a discretionary trust, the **beneficiaries have no automatic right** to receive any of the trust income or capital, and have no legal entitlements under the terms of the trust. All the beneficiaries have is a hope or an expectation that the trustees may exercise their discretionary powers to apply some of the income or capital for their benefit. In some instances, beneficiaries of a discretionary trust may never receive any income or capital.

(b) *Interest in possession trusts (life interest trusts)*

Under a life interest or interest in possession trust, the trustees have **no power to accumulate** the income within the trust. Under the terms of an interest in possession trust, the trustees **must pay out the income** of the trust to a nominated beneficiary or beneficiaries. The trustees cannot hold any of the income back and keep it within the trust.

The beneficiary of an interest in possession trust is called a **"life tenant**". This life tenant is **legally entitled to the net income of the trust**, after taxes and expenses, each year. Under this sort of arrangement, the trustees have no right to retain any of the income within the trust – i.e. they have **no powers of accumulation**.

The term "life tenant" is simply a name for the person entitled to the income of the trust. A life tenancy does **not necessarily** mean a right to the income of the trust **for the rest of one's life**. For example, a life tenant could be given a right to income **until a specified age or a certain point in time**. As we shall see later, if an individual has a **"present right to enjoy the income of a settlement**", an interest in possession exists.

In a typical interest in possession trust, the life tenant will be entitled to income for life and **thereafter the capital of the trust will pass** to another beneficiary called a **"remainderman**". The remainderman is also called the **"reversionary beneficiary",** because on the death of the life tenant, the trust capital will revert to this person.

Generally speaking the life tenant has a right to the income of the trust year on year, but will have no rights to the trust capital. In many interest in possession arrangements, the trustees will have **flexible powers to distribute capital** at their discretion. It is therefore possible for the life tenant to receive a capital distribution, or for the remainderman to receive trust capital before the life tenant has died.

The trust may have more than one life tenant – i.e. more than one person entitled to the income of the trust.

For example, a trust can be set up such that three beneficiaries are entitled to the income of the trust year on year, each receiving a one-third share of the annual trust income.

As well discretionary trusts and interest in possession trusts, there are a few other types of trusts of which you should be aware;

(c) *Accumulation and maintenance ("A&M") trust.*

An A&M trust is "hybrid" – it is a cross between a discretionary trust and an interest in possession trust. It benefited from **certain tax advantages, many of which have been eroded since 22 March 2006**. We will look at these tax rules in a later chapter.

A&M trusts were **commonly set up by parents and grandparents** for the benefit of their children and grandchildren.

(d) Bare trust

Probably the simplest type of trust arrangement is a **"bare" trust**. A bare trust is a nominee arrangement whereby the trustee holds property on behalf of the beneficiary and **acts in accordance with the beneficiary's wishes**. Whilst the trustee is the legal owner of the trust property, the trustee has no discretion, and the beneficiary is absolutely entitled to the assets of a trust.

A typical example of a bare trust arrangement will be a parent setting up a bank or building society account for his child. The parent acts as bare trustee and holds the property on behalf of the child. Any interest earned on that bank or building society account is essentially the income of the child, and the child can call for both the income and capital held in the account at any time.

(e) Charitable trusts

Most charities are legally constituted as **charitable trusts**. Charities will typically have a Board of Trustees who will decide how to apply the income and capital within the trust. Essentially charitable trusts are discretionary trusts whose funds must be applied for charitable purposes. As these trusts are set up as registered charities, they are exempt from taxation.

(f) Protective trust

A protective trust is a special type of trust which gives the beneficiary a right to the income of the trust in much the same way as an interest in possession. However, the terms of the trust are such that **the right to income will terminate** either on the bankruptcy of the beneficiary or on any attempt by the beneficiary to sell or otherwise dispose of his/her life interest. A protective trust may be considered by a settlor who wishes a beneficiary to have a right to income, but who fears that that beneficiary may try to sell the life interest at some time in the future.

By creating a protective trust, the settlor gives the beneficiary the right to income whilst at the same time **guaranteeing that the assets of the trust should not be put at risk** by any irresponsible actions of the beneficiary.

For the remainder of this course on trusts, we shall concentrate on the 3 most common forms of express private trusts – i.e. discretionary trusts, interest in possession trusts and accumulation and maintenance trusts.

1.6 The taxation of trusts

In the next chapter we shall have our first look at the taxation of trusts. Before we do so, let us briefly summarise the sort of tax issues we shall be considering in future chapters.

On the creation of a trust, the settlor will transfer assets to trustees. This **transfer of assets** will have **inheritance tax and capital gains tax consequences**.

From an inheritance tax point of view, the transfer will either be immediately **chargeable or potentially exempt**, depending on the type of trust being set up.

Assuming the gift is not a gift of cash, the transfer will also have capital gains tax implications, as the gift by the settlor to the trustees is treated as a **disposal at market value for CGT purposes.**

A **body of trustees is a chargeable person** in itself and has its own distinct legal personality. The trustees will usually invest the assets transferred to them by the settlor, and those investments will produce income.

Typically trustees will have rental income on investment properties, interest on bank or building society accounts, and dividends on shares. As the trustees are a chargeable person, they will have an **income tax liability** on that income and will have to file self-assessment **tax returns** in the normal way.

From time to time, the trustees may choose to **dispose of certain assets** – e.g. investment properties and shares – and any **gains** on those disposals will be chargeable to **capital gains tax**. In addition, if a trustee **appoints an asset to a beneficiary,** this is a **disposal** by the trustees for CGT purposes and capital gains could arise.

Finally, if a trustee distributes an asset to a beneficiary, this could be a **transfer of value** for IHT purposes.

Remember that trustees will apply income and capital for the benefit of the beneficiaries nominated in the trust deed. If trustees **distribute income to a beneficiary,** either at their discretion or in accordance with the beneficiary's entitlement, that income is charged to **income tax in the hands of the beneficiary.** In certain circumstances, beneficiaries could also pay inheritance tax on the distribution of an asset to them by the trustees.

Over the course of this study manual, we shall look at inheritance tax, capital gains tax and income tax on UK trusts, and consider how tax charges arise to the settlor, to the trustees and to the beneficiaries.

1.7 Residence of trustees

The residence of the trustees of a trust is important for income tax and capital gains tax in the same way as it is for individuals.

If the trustees are treated as **UK resident, they will be taxable on their worldwide income and gains.**

If the trustees are treated as **non-UK resident they will only be taxed on UK income**. Capital gains made by overseas trusts are not chargeable on the trustees. However such **gains can be attributed to a UK settlor or UK beneficiaries.**

Trustees of a trust are treated as a single person for tax purposes. ITA 2007, s.474

There is **one residence test for both income tax and capital gains tax**.

A trust will be treated as **resident in the UK** for income tax and CGT purposes if either: TCGA 1992, s.69 ITA 2007, s.475

1. **all** the trustees are UK-resident, or
2. at least **one trustee is resident in the UK**, and the **settlor was domiciled, resident or ordinarily resident** in the UK at the time when he made the settlement.

Example 1

Which of the following statements is FALSE?

a) A beneficiary of an interest in possession trust is entitled to the income of the trust.

b) The trustees of a discretionary trust have the right to accumulate income within the trust.

c) The trustees of an accumulation and maintenance trust must pay out the income of the trust to the children or grandchildren of the settlor.

d) A settlor can benefit from a trust that he/she has created.

Answer 1

C is false.

Trustees of an A&M trust can accumulate income.

An A&M trust is similar to a discretionary trust.