Principles of trusts

We’ve all heard of ‘trusts’ in relation to our finances, but what are they and how can they be of benefit to us? Edward Stanley explains

How attractive are the following concepts? Providing financial security for your family and future generations? Securing pension arrangements? Investing funds? Leaving assets for worthy causes? Protecting your assets from third parties? These are just some of the situations where a modern-day trust is applied. All very appealing, no doubt, but what on earth is a ‘trust’ and how can this apparently mysterious device be of practical benefit?

So, what is a ‘trust’? A trust best describes the situation where one person (known as the ‘Trustee’) is given an asset by someone else (the ‘Settlor’) for that person to hold ‘on trust’, that is for the benefit of a third person (the ‘Beneficiary’), usually subject to various terms. The relationship between the Trustee and the Beneficiary is said to be a ‘Trust’ and is governed by numerous rules and obligations.

Trusts in the modern world

Trusts have a very broad range of application in domestic life, and in the world of commerce. Some typical illustrations follow.

Wealth Preservation Tax, we can be comforted, will remain a constant in ever changing times. The Trust can be used to plan to reduce or even avoid taxes charged on benefits received and on formal ownership of property.

All of us would prefer to avoid unnecessary income tax, capital gains tax and inheritance tax both now and in the future. Higher-rate taxpayers can save subsequent tax by transferring assets into a trust. Income tax earned by the capital assets will disappear because the asset will have been given away. Capital taxes will be avoided if the asset’s capital value increases as the asset will belong to the trust. Inheritance tax payable on death will be avoided as the asset will not form part of the taxpayer’s estate. Some examples:

- Pay into a Trust an amount up to the prevailing nil rate band (currently £325,000) every seven years without any lifetime inheritance tax becoming due on that transfer. For married couples or civil partners the limit is £650,000.

- Create growth in asset value outside your estate. For example, create a Trust with a modest amount of cash or take out a large loan to acquire capital assets. Over time the loan is repaid and the growth in value of the assets remains in the Trust, not in the Settlor’s estate.

- Transfer into a Trust assets having a low value but potential for large growth. The value transferred from the Settlor’s estate is small and all future growth occurs outside the estate.

- Leaving business property on death to a spouse wastes tax relief. A gift to a spouse or civil partner is exempt. Business property qualifying for 100 per cent relief should be given to lower generations or to appropriate Trusts. This overcomes the problem that such property, if left to the surviving spouse, may become an investment rather than a trading asset, losing entitlement to business property relief on the spouse’s death. If the spouse may need the business assets, place them into a ‘wait-and-see’ discretionary Trust and, if needed, distribute to the surviving spouse after the first spouse’s death. Leave a legacy to one or more pilot Trusts creating a nil rate band for inher-
Estate Planning Trusts can provide security for the family and future generations, for example, by giving away assets into a Trust set up in your lifetime or by making a gift into a Trust upon your death. This has the effect of ring-fencing the funds for specified and/or prospective Beneficiaries. Protective Trusts protect family funds or property from a financially vulnerable or spendthrift child. The child would receive some benefit but core funds would not be at risk.

Asset Protection Trusts can be particularly helpful if you anticipate that your assets may be exposed to risks including: Claims (whether actual or prospective) from your own creditors ‘Forced heirship’ laws, where you may be subject to the laws of a country which dictate that on your death your property must be dealt with in a certain way. However, simply placing assets into a Trust to defeat creditors could be unlawful and liable to be set aside. Again, careful advice needs to be taken when considering any such steps. Trusts themselves incur tax!

Bear in mind that the trust is not a magic wand and tax may not vanish completely. Certain types of Trusts attract tax charges. The basic rate of tax applicable to trusts for income tax is 50 per cent on rental and savings income and 42.5 per cent on dividends. Advice is essential to see whether there can be any reduction in the amount of tax suffered by trusts.

Beware of the distinction, which is not always clear, between tax avoidance and tax evasion. The former is legitimate estate planning carried out to prevent a tax from falling due in the first place. The latter is a criminal scheme disposing of tax that has already fallen due. It is wise to be aware of this when considering any attractive suggestions that promise to make your current tax liability disappear!

HMRC are razor sharp in identifying any sham or artificial arrangements entered into, ostensibly giving away property into Trust but in fact reserving for the Settlor a benefit and/or a degree of control over that property; in such an event tax will be charged according to the transaction’s true nature. The law will change to deter such arrangements. It is essential that you take proper legal advice before committing to any such arrangement.

Who would you trust? As someone creating the Trust by giving away assets, you will need to ensure that you make the right appointment of Trustees. Trustees are in a fiduciary position to the Beneficiaries. They must act in good faith and with the utmost integrity, putting the interests of the Beneficiaries first at all times. As the Trust may exist for many years, you need to be assured that what was once your own capital is administered properly. You need not only to make the right choice of Trustee but also to ensure that the Trust deed is drafted with the utmost care and in anticipation of all reasonably foreseeable developments.

Why dispose of your assets? There are many advantages to be obtained from setting up a Trust. Why would you be interested in so doing? You have available funds from the sale of your practice.

Your practice may be about to undergo restructuring, from the introduction of new partners to the acquisition of land; cross-option agreements need to be set up; you wish to protect your assets; you wish to make provision for your family and future generations. There are, however, many pitfalls in this complex area of the law. Legal advice should be taken only from those with sufficient expertise and experience.

This is not intended to be a detailed consideration of the law and advice should always be sought as to the options that might be suitable for your situation.