AF1/J02 Trusts
Part 1: Basic principles

To quote Oscar Hammerstein, "let's start at the very beginning, a very good place to start". The study of trusts can seem daunting and complex so it's very important to get to grips with the basics before moving on to the more complex areas.

The milestones for this part are to understand:

- The principles of a trust.
- The main uses of a trust
- The main types of trust
- How trusts can be created

The principles of a trust

A trust is a method of owning property so that the **legal** and the **equitable** rights to the property are split. Let's try and put that into simpler language.

Individuals own most property on an outright basis. They own it (legal rights) and can do what they want with it (beneficial rights). Under a trust, one or more persons own the property, but the benefits of/from the property belong to others.

Here is a simple example that will illustrate the key principles and identify the main parties together with their responsibilities

Tom is organising a party for Dick who is leaving the company. Tom can't attend so he gives Harry £300 to pay for the food and drink.

Tom, who in trust language is the **settlor**, has set up a trust and given Harry money instructing him how it is to be used. Harry is the **trustee** and is the legal owner of the money but he cannot spend it as he wishes. He must spend it to buy food and drinks for Dick and the other guests who are the **beneficiaries**.

In this case Harry is both the trustee and a beneficiary. That is allowable but Harry can't treat himself more favourably by buying himself champagne and everyone else lemonade.

If Harry used the money for his sole benefit the other beneficiaries could take action to enforce the conditions of the trust.

Alternatively Tom could appoint another trustee or better still himself to ensure that Harry acts in accordance with the trust instructions

Should Tom be able to attend the party he's not allowed to use the trust money to buy himself a drink. A settlor cannot normally benefit from the trust.

Putting all this together a trust can be defined as:

- An arrangement where the settlor transfers a legal obligation to the trustees
- To deal with the trust property over which the trustees have control
- For the benefit of the beneficiaries who may enforce the obligation

The main uses of a trust

Trusts are a useful tool in many aspects of financial planning. Here are some examples:

- **As a tax planning tool** The most common use is to avoid or reduce an individual's IHT liability. At its simplest a term policy can be written in trust so rather than the policy proceeds being paid to the deceased's estate they are paid directly to the trustees.
- **To allow the settlor to retain some control over the property.** This is a common use where the settlor may have doubts over the recipient (or their spouse) to use the gift wisely. A Trust allows the settlor to retain some control.
- **To enable property to be held for those who cannot legally hold it.** A good example is someone who suffers brain damage because of a medical accident. If compensation were awarded, they would not be able to handle this themselves so a trust would be set up and they would be the beneficiaries of this.
- **To enable different people to benefit in succession.** An example might be a widow who remarries. She has sizeable investments and is concerned that her new husband would have insufficient income if she should predecease him. However, she wants to ensure that on his death the money would revert back to her own children rather than to any of his. She sets up a trust that will allow the husband to enjoy the income but on his death the capital will revert to her children.
- Trusts are also used as the basis of unit trusts, pension schemes and charities.

The three parties to a trust

There are always three parties in a trust:

- The **settlor** who creates the trust
- The **trustee** who looks after the trust property and is its legal owner.
- The **beneficiary or beneficiaries** who will benefit from the proceeds of the trust.

The settlor is the original owner of the trust property. The settlor transfers property to **trustees** and instructs them how they are to handle this property.

The settlor has four main responsibilities:

- choosing the type of trust to be set up
- nominating the initial beneficiaries
- deciding the proportion of the trust property each beneficiary will receive and when.
- appointing the trustees

The role of the trustees will be looked at in more detail in a later part. Broadly anyone over 18 can be a trustee. The settlor can also be a trustee, and this can be a wise course of action. Trustees must act unanimously so it isn't usually wise to have too many. Once appointed a trustee cannot be removed by the other trustees except in very limited circumstances. A trustee can voluntarily retire or step down. No trust will ever fail for lack of a trustee and in the last resort a court can appoint replacement trustees.

A beneficiary is anyone who can benefit from the property held in trust. This can be:

- the income generated by the trust
- the capital of the trust
- both income and capital of the trust.

Beneficiaries can be named or they can be described by a family relationship, e.g. my children. There can be one or more named beneficiaries. In the latter case they are assumed to have equal rights to the trust property unless the trust deed states otherwise.

The principle types of trust

One of the most confusing things in the study of trusts is the range of names given to different trusts. Moreover, the same trust is sometimes given different names depending on whether it being used by a solicitor, accountant or financial adviser.

Cutting through all these names there are two factors that will determine the type of trust

- What rights does the beneficiary have to income or capital?
- Can the trustees accumulate income or must they pay it out to a beneficiary?

At one end of the scale a beneficiary will have an absolute right to both the income and the capital. Beneficiaries who are over 18 can demand the property be given to them and the trustees must do this. Neither can the beneficiary's right to the property be taken away. Such a trust is called a **Bare** or **Absolute Trust**. It can also be referred to as a non-flexible trust.

At the other end of the scale beneficiaries may have no rights to receive income or capital as this is solely at the discretion of the trustees. The trustees can accumulate income rather than pay it out. This type of trust is called a **Discretionary Trust.**

The third option is where a beneficiary has a right to receive income from the trust but not necessarily to the capital. Who is entitled to the capital and when this happens will be set out in the trust. Even if the beneficiary has rights to the capital this may not be absolute and can either be at a set date, if a certain event occurs, or at the discretion of the trustees. This is an **Interest in Possession Trust (IIP)**

There is no statutory definition of an IIP trust. It qualifies as such if the beneficiary has **an immediate entitlement to any income produced by the trust**. Strictly speaking it is the beneficiary who has the interest in possession.

If the trust wording allows the trustees to withhold or accumulate income, then it will not be an IIP trust and will be a discretionary trust. On the other hand, if the trust wording allows the trustees to remove the tight to income at a later date the trust will still be an IIP trust until that happens as the beneficiary will still have a right to immediate income. Should the trust assets not produce any income it would still be an IIP because the beneficiary has a right to income.

If the beneficiary has an exclusive right to enjoy an asset within the trust that would also meet the requirements to be an IIP trust. An example of this would be the right to live in a property at less than the commercial rent.

In practice most IIP trusts will be one of two types:

- Flexible Power of Appointment Trust
- Life Interest Trust

Flexible Power of Appointment Trust

As it is an IIP trust there must be at least one named beneficiary. A Flexible Power of Appointment Trust gives the settlor, usually acting alone, the right to change the beneficiaries or the amount to which each is entitled. This is achieved by having:

- default beneficiaries
- potential beneficiaries.

The default beneficiaries must be named. The settlor can replace these or add further ones from the list of persons in the potential category. This normally consists of family relationships such as grandchildren, siblings, nephews and nieces.

Tim set up a Power of Appointment trust with his two children as default beneficiaries. A few years later a daughter is born and Tim adds her to the list of default beneficiaries. Some years later the children are all grown up and he has grandchildren. He can take his children off the default list and promote his grandchildren to it.

Life Interest Trust

This splits the beneficiaries into two classes. The first, called the **life tenant** has a right to income whilst the other, called **the remaindermen**, have a right to capital after the death of the life tenant

Helen is married to Phil. They both have children from previous marriages. Helen wants to gift a substantial sum to Phil but wants the capital to go to her children when she dies. She sets up a life interest trust so that Phil, the life tenant, can have the income whilst he is alive but on his death the capital would revert to her children, the remaindermen.

These three types can be considered the "primary colours" of trusts and the distinction is significant in establishing the tax treatment of the trust. To summarise:

Bare Trust	The beneficiary can demand the trust property at any time. Their rights cannot be taken away
Interest in Possession	Beneficiaries have a right to income as it arises. Beneficiaries have no right to capital. Trustees cannot accumulate income. Beneficiaries must be named Trustees may be allowed to change the beneficiaries
Discretionary	Beneficiaries have no right to income or capital Trustees can accumulate income Beneficiaries can either be named or listed by family relationship

Setting up a trust

A trust can be created by:

- a deed of trust
- orally
- under the terms of a will
- statute e.g. when someone dies intestate and there is a minor child
- the court as in the case of damages awarded to someone who has been badly injured in a car accident.
- It can also be created by the actions of individuals that imply that they wish to set up a trust.

The most common ways of setting up a trust are by a deed, that is a formal decision to set up a trust whilst the settlor is alive, or by a will which sets up a trust following the death of the person making the will. In both cases the individual can set up a bare, IIP or Discretionary trust.

There are three trusts that can only be set up in a will (or through intestacy). These are:

- Bereaved Minor's Trust
- 18 to 25 Trust
- Immediate Post Death Interest Trust

The purpose of a **bereaved minor's trust** is to provide for a minor child after one parent has died. It can only be set up by a parent or step-parent. It is not available to a grandparent or any other relative to gift money to a minor child on their death.

Under a bereaved minor's trust, trustees can accumulate income but the assets of the trust must be given to the child when they are 18. This may seem too risky to the person making the will so an alternative is to set up an **18-25 trust** in the will. This gives the trustees the ability to give the assets to the beneficiary at any time between 18 and 25.

An **Immediate Post Death Interest Trust (IPDI)** is very similar to a life interest trust but it is set up in a will. As with a Life Interest Trust there is a Life Tenant and remaindermen. This particularly useful with second marriages

Jack is a widower and marries Emma. Both have children from their previous marriages.

Jack wants to provide for Emma after his death but if he passes capital to her in his will it will become her absolute property. This means that she could pass it on to her children on her death.

To get round this Jack set up an IPDI trust in his will. The trust property is a mixture of different investments. As the life tenant Emma has a right to the income but not the capital.

On her death the trust property reverts to Jack's children as the remaindermen

This arrangement can also be used with a family home. In the above case on Jack's death the home would pass into the trust. Emma would have the right to live their rent free and on her death the house would pass to the remaindermen.

Other types of trusts

A vulnerable or disabled person's trust.

To be eligible for this type of trust the beneficiary either be a minor child or someone who is mentally incapable and someone who is eligible for one of the following benefits:

- Attendance Allowance (care component at middle or highest rate/mobility component rate at highest rate)
- Personal Independence payment
- An increased disablement pension
- Constant Attendance Allowance
- Armed Forces Independence Payment

It's not really a separate trust but is subject to special tax rules that will be considered in greater detail in a later part.

Married Women's Property Act Trust

This can only be used to put a life policy in trust. It is simple to set up but there are restrictions:

- single life own life policies only
- set up for the benefit of spouse and/or children. These can include both legitimate and non legitimate children as well as adopted children but not step children.
- must be set up at the outset
- no payment to trustees

Charitable Trusts

The Charities Act 2006 listed 13 categories of charitable purposes that would qualify for charitable status:

- Prevention and relief of property
- Citizenship and community of advancement
- Other purposes beneficial to the community
- The promotion of human rights
- Conflict resolution and reconciliation
- The advancement of education
- Religion.
- Health
- Amateur sport
- Environmental protection and improvement
- Science & Culture
- Arts & Heritage
- The promotion of the efficiency of the armed forces of the Crown
- The promotion of animal welfare

A charitable trust can continue indefinitely and can be varied if its original objectives become obsolete.

It also has significant tax advantages:

- Investment income is tax free.
- Disposals to charities are exempt from CGT
- Gains made within the trust are exempt from CGT
- Life and death gifts to CGT are exempt from IHT
- Gifts can qualify for gift aid and payroll giving

To set up a charitable trust:

- The settlor must choose a name for the trust
- Decide what its purpose will be
- Write a deed outlining its purpose
- Recruit trustees
- Decide how the charity will be funded
- Once it is set up it should be registered with the Charity Commission if based in England or Wales and has income more than £5,000 a year.

That concludes this part so you should now understand:

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- The main uses of a trust
- The main types of trust
- How trusts can be created

Further reading

https://www.netlawman.co.uk/ia/guide-to-trusts

https://www.gov.uk/guidance/how-to-set-up-a-charity-cc21a