# AF1/J02
# Part 6: Practical Trust Issues

The milestones for this part are to understand:

- The factors that need to be considered in advising whether a trust should be used.
- The factors that need to be considered in deciding what type of trust to use.

In giving advice on using trusts the main factors that need to be considered are:

- What is the client trying to achieve?
- Would a trust meet these objectives?
- What type of trust should be used?
- What investment wrapper should the trust's assets be place in?

## Client's Objectives

The usual starting point is that the client wants to make a gift either immediately or through a legacy. This may be prompted by altruism and generosity and/or by a wish to reduce a potential IHT liability. Any lifetime gift which is not exempt has the potential to reduce IHT because it reduces the size of the estate. There is no immediate relief other than what is covered by the annual exemption, as the gift will reduce the NRB for the next seven years.

The problem with making an outright gift is that the donor loses control. Putting the gift into trust gives the donor control over how the gift is used which can even extend beyond their death. This could be useful in several situations.

- A gift to a child who the parent considers to be irresponsible and reckless with money.
- The donor has no issues with the recipient but is concerned that their spouse or partner will squander the money.
- The proposed recipient is self-employed, and the donor wants to ensure the gift will not be taken if the business fails.
- The donor wants to make the gift now but wants the beneficiaries to benefit at some point in the future.
- The donor wants to give income to one beneficiary but pass capital to another beneficiary.

Similar issues could arise in making a legacy and making provision for a trust to be set up in the will could also meet these objectives.

Going further into the client's needs the following should be considered:

- Who are to be the beneficiaries?
- How much is the proposed gift or legacy?
- Does the settlor want the flexibility to change these?
- What rights, if any, to the property does the settlor want to give the beneficiaries?
- Is the main objective of the trust to provide income or capital or both?
- Does the settlor require access to capital or income?
- How much involvement does the settlor want to have in running the trust?
- What gifts has the settlor made in the last 14 years?

Apart from giving some control once the gift has been made there is a further IHT benefit if the trust is classed as relevant property as the beneficiary does not own it for IHT purposes.

Jo gives her daughter £300,000 as an outright gift or legacy. She invests this and 20 years later it has grown to £600,000. Her daughter then dies and all the property is in her estate.

If Jo had put this into a discretionary trust it would not be part of the daughter's estate on her death. There could have been periodic and exit charges but these would probably have been much less than what the daughter's estate would have had to pay if it was an outright gift.

## Which type of trust?

The main choice is likely to be one of the three generic types:

- Bare/Absolute
- Interest in Possession
- Discretionary

**Absolute trust**

These are simple to set up. The initial gift is a PET so there will never be an immediate tax charge. It could be useful if the settlor wants to ensure that the rights of the beneficiary(ies) cannot be removed.

On the other hand the settlor cannot change the beneficiary and an adult can demand the property at any time. A minor child can demand the property at 18 when the settlor or trustees may consider it inappropriate.

**IIP and Discretionary Trusts**

Since both are relevant property trusts there is no difference in IHT since lifetime gifts will be CLTs and both can be subject to periodic and exit charges.

An IIP trust must name the beneficiaries although these can be changed if a Flexible Power of Appointment trust is used. Since no one has a right to income or capital from a Discretionary Trust an IIP trust might be seen as giving more certainty although if the settlor of a DT is a trustee this will be mitigated.

If the settlor's objective is to give some beneficiaries income and others capital, a **Life Interest Trust** is likely to be the most suitable. If this is done through a will it is an **Immediate Post Death Interest Trust. (IPDI)**.

In choosing between IIP and Discretionary one factor will be the burden of tax administration. This is much more complex for a DT but can be offset by the trust using Insurance/Investment Bonds as their investment vehicle.

Setting up a discretionary trust on death can be advantageous as being relevant property no one owns it for IHT purposes. A wide range of people can be beneficiaries and the deceased can give the trustees a "letter of intent" leaving their thoughts on how the trust property should be used. Whilst this is not legally binding the trustees will usually follow it. The deceased may request that the property is used exclusively for their spouse whilst he or she is alive. The trustees could also advance loans to the spouse as these would reduce her estate since they would be repayable on death.

One objection to making lifetime gifts into trusts is that the settlor has no access to the capital. This can be mitigated through two types of trust; a loan trust and a Discounted Gift Trust.

## Loan Trust

Rather than making a gift the settlor lends money interest free to the trust on the condition that this is repayable on demand. The trustees will usually invest this in an Insurance Bond and repay the settlor 5% of the original investment each year.

Since it is a loan rather than a gift the outstanding loan must be included in the deceased's estate. Any growth in the bond allowing for the withdrawals will be outside the estate and this will be available to the beneficiaries.

## Discounted Gift Trust

This allows the settlor to place a lump sum into trust whilst retaining a right to regular payment.

The settlor usually invests in an Insurance Bond and places this in a trust. This is normally a discretionary trust, although it could be an Absolute Trust. The settlor would also be a trustee.

An amount of this gift would be the settlor's retained right that can be paid to them. This is the probable amount of income that will be paid to them. This will depend on:

- The amount of income the settlor wants for the rest of their lifetime.
- The individual's age and health as this will influence the amount of income that will be paid to them during their lifetime.

The amount that is treated as a transfer for IHT is the gift less the retained amount. This is an example given by an insurance company that will illustrate the key points.

> Monica is 68 and a widow. She places £500,000 into a DGT. After underwriting the retained amount is established as £371,319 so the gift for IHT purposes is £128,681 (£500,000 less £371,319). There is no immediate charge assuming she has made no CLTs in the previous seven years.
>
> The trustees invest the £500,000 into an Insurance Bond and Monica can take 5% of this each year (£25,000) without incurring a tax charge.
>
> Fifteen years later Sandra dies and the fund value is £357,000 which can benefit the beneficiaries after her death under the terms of the trust.
>
> If it was an Absolute Trust the remaining fund would be distributed to the remaining beneficiaries.

One particular risk with this trust is that there is no guarantee that the income will last for their lifetime as this will depend on the growth in the investment. It's also important that the settlor spends what they receive so as not to increase their estate.

Another factor to consider is that the trustees can only make "modest" capital distributions to the beneficiaries whilst the settlor is alive.

## Flexible Reversionary Trust

This enables the settlor to make a gift that is effective for IHT but still be able to benefit from the trust without falling foul of the GWR and POAT rules.

- The gift would be a CLT
- The trustees then invest this into a series of single premium endowments each with a different maturity date usually ranging from one to 10 years.
- As each matures, the trustees can either claim the proceeds or extend the policy.
- If the proceeds are claimed they are paid to the settlor.

- As the trustees have the power to extend the policies the settlor's right to receive future benefits have no value and the extension is not treated as a future gift by the settlor.
- The trustees have the power to surrender the policies at any time and pay the proceeds to the beneficiaries.
- Alternatively, they can assign these at any time to the beneficiaries.
- Unlike a DGT there is no discount as it is not possible to quantify any withdrawals the settlor might make.

### Legacies to minor children

There are four possibilities:

- A bare trust
- A bereaved minor trust
- An 18-25 trust.
- A discretionary trust

Both a bare trust and a BM trust give the child an absolute right to the legacy at 18. Neither is relevant property so if the child dies before 18 it would be part of their estate.

Like the bereaved minors trust an 18 to 25 trust only be set up through the will of a parent or legal guardian. It gives the trustees flexibility to give the property to the child before their 25th birthday. It enters the RP regime on the child's 18th birthday. There will be no periodic charge as it must end within 10 years and the maximum exit charge is 4.2%.

A discretionary trust gives the trustees complete freedom as to what and when is given to the child.

## Life Assurance Policies and Trusts

There is one situation when a trust should always be used and that is with a protection policy written on an own life basis. If this is not in trust the executors would make the claim and the money would be paid into the deceased's estate. This could create or increase an IHT liability and cause delay in making payment. By placing it in trust the trustees would claim and pay the proceeds in accordance with the trust deed.

In selecting the type of trust the settlor would probably consider who is to be the beneficiary and whether they want the flexibility to change this.

- An absolute trust would be suitable if there was no possibility that beneficiary would never need to change.

- A Flexible Power of Appointment trust would enable the beneficiaries to be named and therefore give certainty as to who would receive the benefits but allow changes to be made as circumstances changed.
- A Discretionary Trust could be suitable but the settlor could not be certain as to who would receive the benefits.

From a tax point of view both a Flexible Power of Appointment and a Discretionary Trust are relevant property trusts but there are unlikely to be any IHT issues. The premiums are technically CLT's but are likely to be exempt either because they fall under the "gifts out of normal expenditure rule or are under the annual exemption of £3,000.
A protection policy has no value until a claim is made so unless a claim occurs just before the $10^{th}/20^{th}$ anniversary and the money is still in the trust at that point there is no possibility of a periodic or exit charge.

If an existing policy is placed into trust the transfer of value is the greater of the premiums paid to date or the surrender value. This is unlikely to be an issue unless the life assured is in seriously poor health, usually defined as a life expectancy of less than two years, when HMRC may argue that the term policy has a value closer to the sum assured.

Putting a life policy into a trust illustrates some of the general benefits of trusts.

- Speed of payment. The trustees can make the payment direct to the beneficiary.
- Certainty of payment. Unlike a will a trust can't be challenged.
- Tax efficiency. The payment from a life policy will not enter the deceased's estate.

## Choosing the investment wrapper

The investment vehicle of choice for most trusts is the Insurance/Investment Bond. Tax only becomes due when there is a chargeable event and the availability of different funds within a single wrapper enables trustees to meet the duty to have diversified investments. They don't produce a true income.

The alternative apart from directly holding assets is to use unit trusts and OEICS. A trust cannot hold an ISA. Investing in unit trusts and OEICs allows the trustees to use their CGT annual allowance but gains more than this will incur a tax charge of 20%. Tax returns will be required for income received in IIP and Discretionary trusts.

One further fact to consider is that before placing an asset is placed in the trust the adviser's client will be the settlor. Once the asset is in the trust the client will be the trustees. They will be responsible for paying the adviser and may have to use some of the trust's income or capital to pay for the ongoing advice.

## Reviewing Trusts

A trust can run for many years so the original circumstances will change. In all cases the first thing the trustees should do is to check the provisions of the trust deed. Apart from the general review of the trusts' investments the following events are likely to trigger an immediate review:

**Death (or retirement) of a trustee.**

Do they need to be replaced? Who would be the most appropriate choice?

**Death of a beneficiary**

This will depend on the type of trust. If it was the beneficiary of an absolute trust it would be part of their estate and the property would be transferred

No action needs to be taken if the deceased person was a beneficiary of a discretionary trust as they have no automatic entitlement to any benefit. However, the trustees should review any letter of intent to see if further action needs to be taken. For example, if the widow/widower of the settlor died, the trustees would have to decide whether to wind up the trust and who should get the benefits. Alternatively, they may decide to continue the trust and would have to consider who should benefit.

If the deceased was a beneficiary of an IIP trust, the trustees will need to check whether they have the power to change the beneficiary and if so who, if anyone, can replace them.

The death of a Life Tenant would usually mean that the trust would come to an end and the property distributed between the remaindermen. However, the trust wording may give a wider range of options. Particular issues could arise if any of the remaindermen were under 18 as some form of trust will need to exist until they reach the age of majority.

**Payment of capital or other benefits**

Th trust deed may give the trustees specific instructions on when capital should be advanced to a beneficiary. In other cases they may have some discretion as in an 18 to 25 trust.

Trustees of a discretionary trust have the greatest discretion to advance income or capital. If there is a letter of intent this should form the basis of their decision but they can decide whether it is appropriate to pay the beneficiary.

That concludes this part so you should now understand:

- The factors that need to be considered in advising whether a trust should be used.
- The factors that need to be considered in deciding what type of trust to use.