LESSON 3 - Understanding Trust Types: Structure, Purpose and Pitfalls

This content is based on our understanding of current taxation, legislation and HM Revenue & Customs practice all of which are liable to change without notice. The impact of any taxation (and any tax reliefs) depends on individual circumstances.

Where content includes case studies or examples these are for illustration purposes and are not recommending a specific course of action.

Past performance is not a reliable indicator of future performance. The value of an investment can go down as well as up and your client may get back less than they've paid in.

Learning Objectives

By the end of this session, you will be able to:

Identify different types of trust and explain their core characteristics

Explain why particular trust structures are used for specific purposes

Recognise key pitfalls associated with different types of trust

Common trust types to watch out for

Trusts created on death

Qualifying IIP trusts

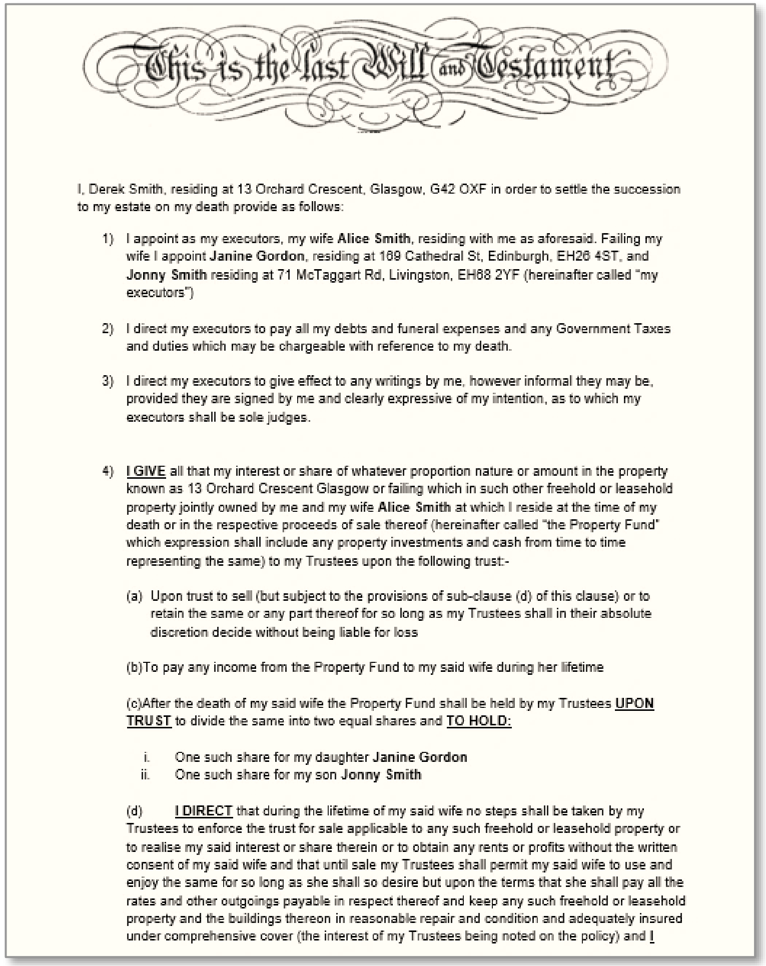
Trusts for vulnerable beneficiaries

Personal injury trusts

Trusts created on death

Will trusts

- Trust doesn't exist until death
- The settlor is the "testator" or "testatrix"
- Trustees may be named (often whomever obtained probate)
- A Will can create multiple trusts
- The Will creates the trust! (no trust deed required)



This is the last Will and Testament

I, Derek Smith, residing at 13 Orchard Crescent, Glasgow, G42 OXF in order to settle the succession to my estate on my death provide as follows:

1) I appoint as my executors, my wife **Alice Smith**, residing with me as aforesaid. Failing my wife I appoint **Janine Gordon**, residing at 169 Cathedral St, Edinburgh, EH26 4ST, and **Jonny Smith** residing at 71 McTaggart Rd, Livingston, EH68 2YF (hereinafter called "my executors")

2) I direct my executors to pay all my debts and funeral expenses and any Government Taxes and duties which may be chargeable with reference to my death.

3) I direct my executors to give effect to any writings by me, however informal they may be, provided they are signed by me and clearly expressive of my intention, as to which my executors shall be sole judges.

4) I GIVE all that my interest or share of whatever proportion nature or amount in the property known as 13 Orchard Crescent Glasgow or failing which in such other freehold or leasehold property jointly owned by me and my wife **Alice Smith** at which I reside at the time of my death or in the respective proceeds of sale thereof (hereinafter called "the Property Fund" which expression shall include any property investments and cash from time to time representing the same) to my Trustees upon the following trust:-

(a) Upon trust to sell (but subject to the provisions of sub-clause (d) of this clause) or to retain the same or any part thereof for so long as my Trustees shall in their absolute discretion decide without being liable for loss

(b)To pay any income from the Property Fund to my said wife during her lifetime

(c)After the death of my said wife the Property Fund shall be held by my Trustees UPON TRUST to divide the same into two equal shares and TO HOLD:

i. One such share for my daughter **Janine Gordon**
ii. One such share for my son **Jonny Smith**

(d) I DIRECT that during the lifetime of my said wife no steps shall be taken by my Trustees to enforce the trust for sale applicable to any such freehold or leasehold property or to realise my said interest or share therein or to obtain any rents or profits without the written consent of my said wife and that until sale my Trustees shall permit my said wife to use and enjoy the same for so long as she shall so desire but upon the terms that she shall pay all the rates and other outgoings payable in respect thereof and keep any such freehold or leasehold property and the buildings thereon in reasonable repair and condition and adequately insured under comprehensive cover (the interest of my Trustees being noted on the policy) and I

A Will can create many different types of trust!

Why create a trust in your Will?

Delay entitlement
for a child

Control successive
interests

Vulnerable
beneficiary

Flexibility

Tax Planning

Protection

Discretionary Will Trusts

12) I give the sum of £250,000 to my Trustees upon trust (hereinafter called the "Trust Fund") to hold subject to the powers and provisions hereinafter declared.

a) My Trustees shall hold the capital and income upon such trusts in such shares with and to such powers and provisions as the Trustees shall at any time or times appoint by deed or deeds revocable or irrevocable.

Start date normally date of death

No entry charge

Periodic/exit charges – gifts in 7 years before death reduce NRB

Settlor alive and UK resident?

Beware of the Bare!

HMRC internal manual
Trusts, Settlements and Estates Manual

Example 1 - bare trust

Mrs A left the residue of her estate to such of her grandchildren as were alive at the date of her death.

She directed that the funds should not be paid to the grandchildren until they respectively attain age 21 years.

Example 3 - not a bare trust

Mr B left the residue of his estate to 'such of my grandchildren as survive me and attain age 21 years'. If any grandchild dies before age 21, his/her prospective share goes to the other grandchildren who do attain that age.

Statutory trusts created on death for children

Bereaved Minor's trusts (s71A IHTA)

- Created by Will of a parent (or intestacy in England and Wales*)
- Bereaved minor - under 18 and at least one parent who has died
- While under 18 no one else can benefit
- Must become entitled to all the capital and any income arising from it by age 18
- No IHT periodic or exit charges

18-25 trusts (S71D IHTA)

- Created by Will of a deceased parent
- Beneficiary must be under 25
- While under age 25 no one else can benefit
- Must become entitled to all the capital and any income arising from it by age 25
- No IHT charges until age 18 – potentially exit charge between 18 and 25

Beneficiary may qualify as vulnerable so special income tax/CGT treatment can be claimed

Bereaved Minor's Trusts

Created by Will

3(a) I give my residuary estate to my son **JOHN** subject to him attaining the age of 18

Created under rules of Intestacy

COPIES OF THIS GRANT ARE NOT VALID UNLESS
THEY BEAR THE IMPRESSED SEAL OF THE COURT

IN THE HIGH COURT OF JUSTICE

The District Probate Registry at Leeds

BE IT KNOWN that Ian John McKenzie

of 123 Anywhere street, Sometown, AB1 YZ9

died on the 31st December 2020
domiciled in England and Wales INTESTATE

AND BE IT FURTHER KNOWN that Administration of all the estate which by law devolves to and vests in the personal representative of the said deceased was granted by the High Court of Justice on this date to

Leon Alfie Mackenzie of Main Cottage, Leston, XY99 1AB

and Leslie Ann Mackenzie of Main Cottage, Leston, XY99 1AB

for the use and benefit of Jack Mackenzie and Jill Macenzie limited until one of them shall attain the age of 18 years

18 – 25 Trusts

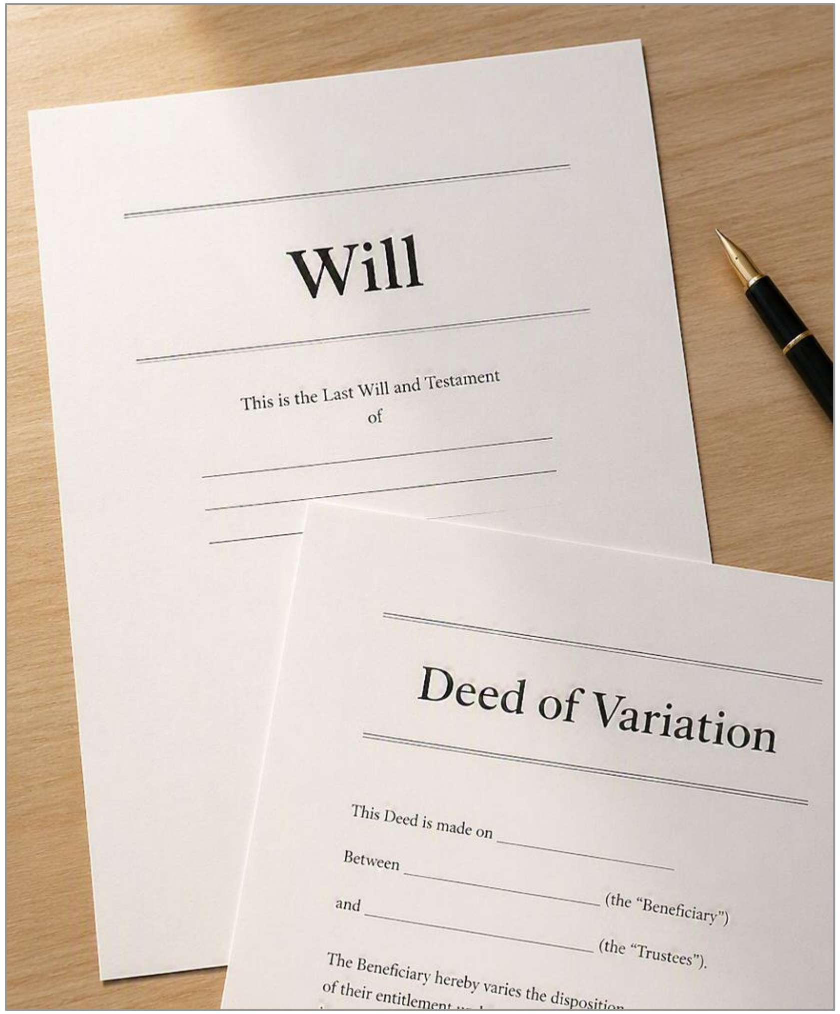
5)a) I give the sum of £200,000 to my son provided he attains the age of 21 years, and until then to apply income and capital for his maintenance, education or benefit.

4) I give my residuary estate to my trustees upon trust for my children who survive me and attain the age of 25 years, in equal shares.

5.1.2 as to the other part for such of my grandchildren **Billy the Kid** and **Luke Skywalker** as shall survive me and attain the age of 25 and if both in equal shares absolutely

Trusts created by Deed of Variation

- Must be within 2 years of death
- Must be in writing and requires consent of those affected
- Trust is created by the deed of variation
- The settlor is the beneficiary who varies their entitlement
- For IHT/CGT purposes the deceased is treated as being the settlor (not for income tax)



Deed of Variation

- David received a £500,000 inheritance from his late mother's estate (his mother died 12 months ago)
- David already has an IHT liability which is going to get worse from April 2027 when his drawdown pension pot is brought into his estate for IHT
- He doesn't need access to the £500,000 and asks his adviser what he should do to improve his IHT position. He doesn't want to make outright gifts to his two adult children at this stage and was thinking about some kind of trust arrangement.
- David's adviser suggests he speaks to a solicitor about a deed of variation as this could be used to create a discretionary trust.

The £500,000 will be out of David's estate immediately (no 7 year clock)

David can be a potential beneficiary of the trust without causing a GWR

The deceased will be treated as the settlor for IHT/CGT

David will be the settlor for income tax purposes

Qualifying interest in possession trusts

Why does it matter? Inheritance Tax

Trust fund in beneficiary’s estate

Trust fund in “relevant property regime”

Absolute/Bare Trust

Qualifying IIP trusts

Non-qualifying IIP trusts

Discretionary Trusts

*Some exceptions e.g. trusts for vulnerable beneficiaries

Qualifying Interest In Possession Trusts

- Trust set up on death of the settlor in which the beneficiary has an interest in possession (immediate post death interest “IPDI”)
- Interest in possession trust set up before 22 March 2006
- A “transitional serial interest”

Most Non-qualifying IIPs set up now are “asset protection trusts” or probate trusts

Flexible trusts – Pre 22nd March 2006

Discretionary beneficiaries

BOX F – DISCRETIONARY CLASS

i. the Settlor
ii. the spouse widow or widower of the Settlor
iii. the children and remoter descendants of the Settlor (including any adopted children illegitimate or legitimised children and step-children)
iv. the spouses widows and widowers of the Settlor's children and remoter descendants
v. such other objects or person or persons or classes of persons as are added under clause 7.8
vi.

IIP beneficiaries

BOX G – DEFAULT BENEFICIARIES

Full name	Share of Trust Fund (%)
John Cooper	50%
Lisa Cooper	50%
	100%

Immediate post death interests – "IPDI"s

5) My Trustees shall hold the Trust Fund ON TRUST

a) To pay the income to my Wife for her life

b) Absolutely for such of my children as are alive at my death and if more than one in equal shares PROVIDED that if any child of mine dies before me leaving a child or children who reach the age of 25 then such child or children shall take and if more than one in equal shares so much of the Trust Fund as that child of mine would have taken on attaining a vested interest

Immediate post death interest trusts (IPDIs)

- Marjorie, aged 75, is the life tenant of an Interest in possession trust created in her late husband, Bill's, Will
- The Will left Bill's share of the property to the trust. The residual estate passed to Marjorie absolutely.
- Marjorie has the right to live in the property and any income generated from any investments.
- On Marjorie's death, the trust fund will pass to Bill's two children from his previous marriage.

The trust property forms part of Marjorie's estate for IHT purposes

Marjorie's NRB/RNRB will be apportioned between her estate and the trust

The transfer into the trust on Bill's death covered by the inter-spouse exemption

Trust property passing to stepchildren so qualifies for RNRB

Apportioning the NRB/RNRB

	Estate	Qualifying IIP trust
Value	£1,000,000	£500,000
Chargeable amount after exemptions/reliefs	£1,000,000	£500,000
Calculate total NRB/RNRB	Nil rate band available - £650,000 RNRB available - £350,000 Total NRB/RNRB available £1,000,000	
Apportion NRB/RNRB	£1,000,000/£1,500,000 = 66.66%	£500,000/£1,500,000 = 33.34%
Calculate IHT	£333,333 x 40% = £133,333	£166,667 x 40% = £66,666

Trusts for vulnerable beneficiaries

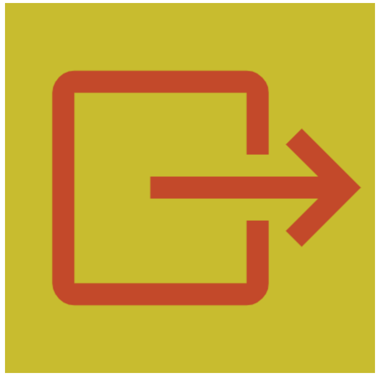
Trusts for the vulnerable

- Can be created by deed, by Will or, by law
- Interest in possession or discretionary trusts
- Conditions to qualify as a “vulnerable beneficiary”
- Restrictions on who can benefit during vulnerable beneficiary’s lifetime
- If election is made special tax treatment can be obtained

Qualifying conditions

Beneficiary

- Someone under 18 whose parent has died (a “relevant minor”) or,
- Mentally or physically disabled and entitled to certain state benefits



Trust terms

- Beneficiary is the only one who can receive income
- Capital distributions to anyone else is restricted to the lower of £3,000 or 3% of the trust fund per tax year

Trusts for vulnerable beneficiaries

1.1 **Beneficiary** shall mean the Life Tenant, any Discretionary Beneficiary or any person or Charity actually or prospectively entitled to any share or interest in the capital or income of the Trust Fund.

1.2 **Charity** shall mean any Entity established only for purposes regarded as charitable under the law of England.

1.3 The **Discretionary Beneficiaries** shall mean:

(a) Alvin Shearer and his issue;

(b) such other persons or Charities as are added under clause 3.

1.6 The **Life Tenant** shall mean Alvin Shearer

4. **TRUSTS DURING THE LIFETIME OF THE LIFE TENANT**

The provisions of this clause shall apply during the Trust Period while the Life Tenant is living.

4.1 The income of the Trust Fund shall be paid to the Life Tenant.

4.2 The Trustees may at any time pay or apply the whole or any part of the Trust Fund in which the Life Tenant is then entitled to an interest in possession to [him/her] or for [his/her] advancement or otherwise for [his/her] benefit in such manner as the Trustees shall in their discretion think fit. In exercising the powers conferred by this clause, the Trustees shall be entitled to have regard solely to the interests of the Life Tenant and to disregard all other interests or potential interests in the Trust Fund.

4.3 Notwithstanding the provisions of sub-clauses 4.1 and 4.2 the Trustees may at any time in any period of 12 months that begins on 6 April pay or apply to or for the advancement or otherwise for the benefit of any of the Discretionary Beneficiaries an amount of income and/or capital of the Trust Fund not exceeding the Specified Amount.

5. **DISCRETIONARY TRUSTS AFTER THE DEATH OF THE LIFE TENANT**

This clause shall apply during the Trust Period after the death of the Life Tenant.

5.1 The Trustees shall hold the capital and income of the Trust Fund upon trust for or for the benefit of such of the Discretionary Beneficiaries, at such ages or times, in such shares, upon such trusts (which may include discretionary or protective powers or trusts) and in such manner generally as the Trustees shall in their discretion appoint. Any such appointment

Trusts for vulnerable beneficiaries

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1.2 **Charity** shall mean any Entity established only for purposes regarded as charitable under the law of England.

1.3 The Discretion

(a) Alvin

(b) such ot

1.7 the **Specified Amount** shall mean an amount which does not exceed the annual limit defined in s 89C(2) of the Inheritance Tax Act 1984.

1.6 The **Life Tenant** shall mean Alvin Shearer

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Good indicator!

Interest in possession trusts more likely to impact means tested benefits than discretionary!

Vulnerable persons election (VPE1)

Election VPE1 required for special income tax/CGT treatment

Election signed by trustees and beneficiary (or legal representative)

Election irrevocable unless trust status changes

Deadline is 12 months after 31 Jan following the tax year

Election ends on death

Income tax and CGT implications

Mr and Mrs Smith set up a discretionary trust for their daughter Evie who is physically disabled. The solicitor who drafted the trust ensured the terms around distributions were restricted enough to allow it to qualify as a trust for a vulnerable beneficiary.

The trust invests in a GIA portfolio which has generated dividend income of £10,000 this tax year. The trustees have also made disposals which has resulted in capital gains of £10,000 this tax year.

Evie has no income or gains in the current tax year. The trustees make a vulnerable person's election.

	Income Tax	Capital Gains Tax
Trustees calculate tax liability based on rate on the "normal" basis	£10,000 x 39.35% = £3,935	(£10,000 - £1,500) x 24% = £2,040
Calculate tax liability that beneficiary would have incurred personally	Nil. £10,000 dividends covered by personal allowance	(£10,000 - £3,000) x 18% = £1,260
Trustees can claim the difference between these as a reduction	£3,935 - £0 = £3,935	£2,040 - £1,260 = £780

Trustees complete tax return and pay £1,260 tax to HMRC

Inheritance tax

~~Entry~~

PET where settled by someone else

~~10 year~~

In vulnerable beneficiaries estate for IHT*

~~Exit~~

No exit charges

(18-25 may be subject to an exit charge)

*Bereaved minor’s trusts/18-25 trusts are not in the beneficiaries estate

Bespoke trust or standard discretionary trust?

Tax factors

Non-tax factors

Bespoke trust or standard discretionary trust?

	Qualifying Vulnerable Trust	Standard Discretionary Trust
Income	Assessed on trustees (beneficiary's rate)	Assessed on trustees at trustee rates (reclaimable on distribution)
Bond gains	Assessed on trustees (beneficiary's rate)	Assessed on settlor, trustees or beneficiary
CGT	Assessed on trustees (beneficiary's rate)	Assessed on trustees at trustee rates
IHT	In beneficiary's estate	Relevant property regime
Non-tax factors	Capital or income distributions can impact means tested benefits Restrictions on distributions to others during vulnerable beneficiary's lifetime	Capital or income distributions can impact means tested benefits No restrictions on distributions to others during vulnerable beneficiary's lifetime

Personal Injury trusts

Personal injury trusts

- Created to hold compensation payments
- The settlor is the injured person
- Trustees will be named in the trust deed (deed usually drawn up by a solicitor)
- Generally a bare trust with injured person as beneficiary
- Protects means tested benefits
(capital disregarded for 52 weeks)

Personal injury trusts

Trust fund normally in beneficiary's estate

Similar tax considerations to making personal recommendation

Trustee bank account useful so trustees can pay for things directly

HMRC Trust Registration Service

Type of Trust	TRS requirements
Will Trusts	Exempt for 2 years from date of death of the testator
Trusts created by DOV	Needs registered within 90 days of the date of the DOV (regulations now amended to align with Will trust exemption)
Statutory Trusts (BMT,18-25)	Exempt (not an express trust!)
Personal Injury Trusts	Exempt
Vulnerable Person's Trusts	Exempt

Ireland's CRBOT has fewer exemptions!

Learning Objectives

By the end of this session, you will be able to:

Identify different types of trust and explain their core characteristics

Explain why particular trust structures are used for specific purposes

Recognise key pitfalls associated with different types of trust

Any questions?

Thank you

M&G