TAX FACTSHEET

WHAT IS A TRUST?

A 'trust' is an equitable fiduciary obligation which binds a person, a 'trustee', to hold property, the 'trust property', separately from his own personal assets and deal with that property for the benefit of persons known as 'beneficiaries'. A trust has no legal personality, so it is the trustees (whether individuals, a company, or a combination of the two) who hold the property and are personally accountable to the beneficiaries in relation to it. The liability of a trustee is personal, so it does not pass automatically to successor trustees on the resignation, retirement or death of a trustee (although in practice, it is conventional for a retiring trustee to seek an indemnity from the continuing trustees). If a trustee acts negligently in a way which is not authorised by the trust instrument, this is a 'breach of trust' and the beneficiaries may sue the trustee for the breach.

The person who transfers assets to the trustees to hold as trust property is the 'settlor' (known as the 'grantor' in the US). The terms of a trust are set out in the trust instrument, which is likely to be in the form of a deed or a declaration of trust in the case of a transfer in the settlor's lifetime. Trusts may also be established under a Will and come into existence on the death of the testator. The terms of the trust will typically include the following:

- The identity of the trustees
- Whether the trust is irrevocable or revocable
- A description of the trust property
- The identity of the beneficiaries
- The length of time for which the trust will continue
- The terms on which the trustees may distribute income or capital of the
- trust to beneficiaries
- Other powers vested in the trustees, such as the power to add or remove
- beneficiaries, the power to wind up the trust etc.
- The identity of a protector, whose consent might be required before the

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trustees may exercise certain powers under the trust instrument

- The administrative powers of the trustees for operating the trust on a day to day
- basis
- The arrangements for the removal or appointment of trustees (powers often vested
- in a protector)
- The governing law of the trust

Often, the settlor will provide the trustees with a more personal and non-legally binding side letter, known as a 'letter of wishes', setting out the settlor's views for how the trust fund might be used, and in particular how the settlor envisions that the trustees will exercise some of their powers of discretion under the trust instrument, such as the power to distribute capital of the trust.

The historical background to trusts

Trusts and trust law had their beginnings in England in the 12th century. Crusaders leaving for war often transferred ownership of their estates to someone else to manage in their absence, in the expectation that on eventual return to England ownership would be restored to them. English law, based as it was on Roman law, did not recognise the rights of anyone other than the legal owner. Disputes arose where the owner refused to return the land and since the crusader had no valid claim under English law, the only recourse was to petition the King. These disputes were often resolved by the Lord Chancellor recognising the crusader's rights in equity, and thus the owner would be considered to have been holding the land as 'trustee' for the crusader as 'beneficiary' and compelled to return it. From these origins, trust law developed in England and became a sophisticated part of the country's legal system which was, over time, exported to many other nations.

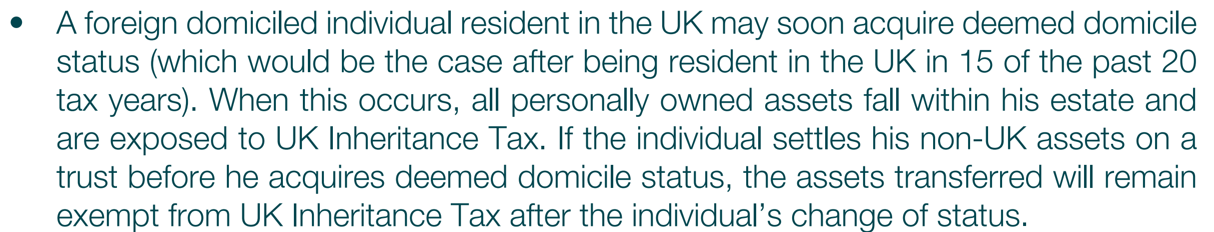
In addition to England and Wales, a form of trust law exists in many jurisdictions which fell under the administrative influence of Great Britain. This includes the US, Canada, Australia, New Zealand, South Africa, Jersey, Guernsey, Bermuda, BVI and Cayman Islands. All of these countries have a long-recognised and respected trust law supported by their courts. Even some civil law jurisdictions such as Liechtenstein provide for a form of trust, and the Swiss authorities are currently considering the introduction of a Swiss domestic trust law. If adopted, this would complement, rather than replace, the established practice of using Swiss trustees whilst retaining a choice over the governing law of the trust.

Why are trusts used?

There are many reasons why trusts remain popular as flexible vehicles to hold family wealth. Here are just a few scenarios:

- A successful entrepreneur wishes to preserve and hold family wealth together over a long term period, rather than see the wealth divided between the next generation of the family and potentially dissipated.

- An individual may be domiciled in a country with laws ('forced heirship') which require wealth to be split on death on a statutory basis between spouse and children in a defined percentage. Or the individual may be domiciled in a country which permits only male heirs, or the oldest male heir, to benefit from his estate. Settling assets on trust during lifetime may offer a method of providing greater flexibility in allowing a wider group of beneficiaries to access financial support in future.



- A foreign domiciled individual resident in the UK may soon acquire deemed domicile status (which would be the case after being resident in the UK in 15 of the past 20 tax years). When this occurs, all personally owned assets fall within his estate and are exposed to UK Inheritance Tax. If the individual settles his non-UK assets on a trust before he acquires deemed domicile status, the assets transferred will remain exempt from UK Inheritance Tax after the individual's change of status.

How do trusts operate in practice?

The process of transferring assets to trustees is a committing step, since the wealth becomes property of the trustees and ceases to be the property of the settlor. Taking advice so that the trust deed and the letter of wishes accurately reflect the settlor's intentions as regards how the trust fund will be dealt with, who will benefit (and to what extent and in what circumstances) and what powers will be vested in the trustees is crucial. It is not uncommon, especially with trusts which are governed by the law of an overseas jurisdiction, for the trust deed to provide for the appointment of a protector. The protector is likely to be a trusted adviser to the settlor and his family, and he may be given certain powers under the trust deed (possibly the power to replace trustees). It is also typical that the trustees are required to obtain the consent of the protector before they are permitted to exercise certain powers ('consent powers'). There is flexibility as to which trustee powers might require the protector's consent, but the power to add or exclude beneficiaries (if the deed contains such powers) and the power to change the governing law of the trust are common as consent powers. These considerations are all part and parcel of ensuring that the trust deed meets the settlor's expectations, and contains safety mechanisms which give comfort to the settlor.

In practice, it is usual for the trustees to have a close and collaborative relationship with the beneficiaries, meeting or conversing regularly so as to understand their financial needs and requirements through regular dialogue. This ensures that the trustees, operating within the powers and limitations of the trust instrument, can exercise their discretion on distributions with all relevant information at their disposal.

It is not always the case that trustees have discretion in relation to distributions of income. Although many trusts are established in such a way that the trustees can make distributions to one or more of a class of beneficiaries subject to their discretion (or make no distributions at all, if they choose), there are also trusts which provide for an 'interest in possession' in favour of a beneficiary, where the beneficiary has a right under the terms of the trust to receive the income, or a fixed portion of it.

How are trusts taxed?

UK resident trusts

UK resident trusts are subject to income tax and Capital Gains Tax in their own right. For discretionary trusts where no individual has a right to the income, most types of income are subject to income tax at 45%, with the exception of dividend income which is taxed at 39.35%. These rates apply to trust income in excess of £1,000 (this first amount being taxed at 20% only, and 8.75% for dividend income). A distribution of income from a discretionary trust is deemed to have been paid net of 45% income tax, so a beneficiary receiving an income distribution who is personally taxed at a lower Income tax rate than 45% will be able to obtain a tax refund. The trust needs to ensure that

it has actually paid enough tax to support the 45% credit attaching to distributions to beneficiaries. If there is a shortfall, the trustees have to pay the difference. A trust which provides for an interest in possession in favour of a beneficiary, so that the beneficiary has a right to the trust income, is liable to income tax at the rate of 20% (and 8.75% on dividend income).

In spite of the fact that UK resident trusts are liable to income tax in their own right, the settlor may also be liable to tax on the same income if the trust is 'settlor-interested'. A trust is settlor-interested if he/she (or his/her spouse) can benefit in any way under the trust. Where this is the case, the trustees provide the settlor with details of the income which they have paid tax on, and the amount of the tax paid by the trustees, and the settlor then reports the trust income on his return and obtains a credit for the tax paid by the trustees.

UK resident trusts pay Capital Gains Tax on their capital gains at the rate of 20%, except for gains on residential property or carried interest where the enhanced rate of 28% applies. A trust is entitled to an annual exemption of half that to which an individual is entitled. The trust annual exemption £3,000 for 2023/24, falling to £1,500 in 2024/25.

Non-UK resident trusts

Non-UK resident trusts are only subject to UK income tax on UK source income, and are only liable to UK Capital Gains Tax on gains arising on sale of UK real estate. However, there are anti-avoidance provisions for both income tax and Capital Gains Tax which can impute income and capital gains to UK resident settlors with an interest in the non resident trust, and to UK resident beneficiaries who receive distributions from the trust. UK source income of a non-UK resident trust can be imputed to a non-resident settlor who has retained an interest in the trust. Some of these provisions do not apply where the UK resident settlor or beneficiary is not domiciled in the UK. A detailed consideration of these provisions is beyond the scope of this Fact Sheet, but any of the Rawlinson & Hunter private client partners would be happy to provide more information.

Trusts and Inheritance Tax

A UK domiciled settlor of a trust is liable to Inheritance Tax at a rate of 20% on the value of assets transferred to a trust, after deduction of any nil rate band which is available There are reliefs available where the assets settled are agricultural property or relevant business property, and the detailed conditions for these reliefs are met. The trust itself will also be liable to UK Inheritance Tax at up to 6% on the tenth anniversary of the trust and every ten years thereafter, and also on the occasion of assets leaving the trust (when the rate will be a fraction of the rate charged on the previous ten year anniversary, depending on how much time has elapsed). This charge on the assets leaving the trust does not apply where income of the trust is distributed. Different rules apply to trusts for vulnerable persons.

If a UK domiciled settlor retains an interest in the trust and is not excluded from benefit, this will result in the transfer to the trust being treated as a 'gift with reservation'. The consequences of this are that, notwithstanding the liabilities on the settlor and trustees as described above, the asset value of the trust on the settlor's death would fall back Into his/her estate. It is therefore conventional for a UK domiciled settlor to be excluded from benefit under the terms of the trust.

If the settlor is foreign domiciled (and hasn't become deemed domiciled by having spent 15 of the previous 20 tax years as a UK resident), there is no Inheritance Tax charged on the transfer of assets to the trust provided that the assets are foreign situated. Furthermore, there would only be a charge to Inheritance Tax on the trust on the ten year anniversary events in respect of UK assets, and not in respect of foreign assets. As long as the trust assets remain exempt excluded property (foreign property), there is no Inheritance Tax either on the ten year anniversary events or on the occasion of assets leaving the trust.

It is noteworthy that where the trust assets are exempt excluded property because they are foreign assets settled on trust by a non-UK domiciled settlor, the 'gift with reservation' rules described above do not apply. It is therefore not uncommon for a non-domiciled settlor of an excluded property trust to be a beneficiary.

Concluding observations

Trusts are highly flexible vehicles which can meet important objectives for families in relation to strategic planning, succession and wealth preservation. Trust deeds can be drafted which reflect the wishes of the settlor and the long term financial needs of the settlor's descendants. The tax treatment of trusts is highly complex and will depend on the tax status and circumstances of the settlor and the settlor's family. All of the Rawlinson & Hunter private client partners are experienced in advising on trusts and their use, and in acting as trustee through our trust corporation, The R&H Trust Co (UK) Ltd. For international clients, the Rawlinson & Hunter overseas offices provide a full trustee and trust administration service. If you require more information, please speak to one of our partners.

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