Types of Trusts

Herrington Carmichael SOLICITORS

There are many different names and types of Trusts. This fact sheet will give you a very brief synopsis of the main types or names that you are likely to encounter.

Life Interest Trust

In the case of a Life Interest Trust, an individual (the "Life Tenant") has a right to receive income from Trust Property for his or her lifetime. Instead of receiving income there may be a right to occupy a property as a home. The Life Tenant of such a trust has what we call a "Life Interest". When the Life Tenant dies, the Trust Property passes to another person or persons who are usually the ultimate beneficiaries of the Trust.

One of the most common uses of this trust is in second marriages where property is held on trust for the benefit of the second spouse during his or her lifetime after which the property goes to the children of the first marriage or the children of both marriages.

Flexible Life Interest Trusts

This is a trust where there is a Life Tenant who has a right to income but the Trustees are given the option to terminate this right. In its place they can substitute Discretionary Trusts, create new Life Interests for other people or simply terminate the trust and hand over the property to the life Tenant or some other person.

These powers are often used as part of a tax planning exercise, normally intended to move the benefit of the trust from one generation to another at minimal inheritance tax cost. These trusts can be created in lifetime trusts and in Wills, and as with ordinary Life Interest Trusts, the Inheritance tax treatment depends on how the trust was created.

Discretionary Trust

A Discretionary Trust is one under which no one person has any entitlement to either capital or income of the Trust Fund. Instead, a group of people are named as potential Beneficiaries of the Trust. The Trustees are given discretion to decide which of the Beneficiaries is to receive anything and how and when they are to receive it. Generally the person creating the trust will give the Trustees some guidance as to how the Trust is to be used.

Most frequently these trusts are created to provide flexibility over funds or to ring-fence assets from being eroded by divorce, failed businesses, bankruptcy or inheritance tax on the death of a Beneficiary. Because they are so flexible they can be useful when the person making the trust cannot decide what to do.

Relevant Property Trust

This is not a separate class of trust in itself; it merely explains how a trust is to be taxed. Both a Life Interest Trust and a Discretionary Trust can be a Relevant Property Trust as (in certain circumstances) they can both be taxed under the Relevant Property Regime.

A Relevant Property Trust is subject to inheritance tax when it is created and then every 10 years or when property comes out of the trust. However, it should be borne in mind that while there is a theoretical liability to tax, it may be that no tax is in fact payable. The rate of inheritance tax payable on the creation of such a trust is 20% if created during your lifetime but if created on death, or within 7 years prior to death the rate is 40%

Bare Trust

These trusts are not flexible and in practice their use is limited. A Bare Trust arises whenever property is given to a child who is a minor. English law provides that a child cannot give a valid receipt for property. Therefore property given to that child must be held on his or her behalf until they reach the age of 18. The property belongs to the child

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as does any income or any capital gains that might be realised buying or selling trust assets.

A Bare Trust can also arise by a simple declaration of trust being made naming Trustees and defining their powers.

Young Person's Trust

The Finance Act 2006 created a number of new classifications of trusts for young persons. These trusts must always end or be converted into one of the other classes of trust on or before the child's 25th birthday. The inheritance tax treatment of these trusts depends upon a number of factors and is complex - we recommend that advice is sought.

Vulnerable Person's or Handicapped Person's Trust

Governments have long accepted that certain people cannot be expected to handle large sums of money and various mechanisms have been developed to enable assets belonging to or destined for someone who is in some way handicapped to be looked after and used for that person's benefit.

The Court of Protection and Lasting Powers of Attorney are two of these mechanisms, about which further details can be found on this website. Inevitably Trusts also feature and over the years successive governments have provided tax exemptions for trusts set up for the benefit of handicapped and vulnerable people.

Provided that the Trust complies with certain requirements and the beneficiary comes within the definition of a handicapped or vulnerable person, then these tax breaks can be very beneficial.

Discounted Gift Trust

This is an insurance linked scheme often sold by Financial Advisers. It is unusual from an inheritance tax planning perspective in that money can be given away while at the same time the giver can retain some income from those funds. This scheme is particularly useful for older people whose life expectancy is less than 7 years but can also be used for longer term planning. It is linked with Investment bonds and the charges for creating and maintaining these schemes are quite high.

The scheme is generally only suitable for people with cash or near cash assets available to be invested. One big disadvantage of these schemes is that unless considerable care is taken the income stream ceases after 20 years. With our ever ageing population this has caused problems for people who have used this scheme and never dreamed that they would live that long.

Gift and Loan Trust

This is another insurance linked scheme often sold by Financial Advisers. As with the discounted gift scheme it can be suitable for people with cash assets available who need to continue receiving income from those assets. Unlike the discounted gift scheme it is usually most suitable for longer term planning.

The success of this scheme relies heavily on stock markets increasing and over the last 10 years these schemes have had limited efficiency but during times of rising stock markets have proved a highly effective way of passing on wealth. Most of the disadvantages of the Discounted Gift scheme i.e. costs, the need for cash investment and the 20 year income scheme apply.

Pilot Trusts

This can be almost any sort of trust. The name relates not to the type of trust but to the manner of its creation. Generally a Pilot Trust is a trust created in a lifetime, normally with a nominal sum of money. The trust remains dormant until substantive property is added to it. Most commonly this is done by way of a gift to the trustees under a Will. Once the property is received the Trustees activate the trust. The object of Pilot Trusts was either to "gift wrap" and protect funds from issues such as the divorce or bankruptcy of a beneficiary, or to enable someone to create a cluster of Nil Rate Band trusts as part of an inheritance tax planning exercise.

If you require advice on setting up a trust, please contact our Private Client team on 0118 977 4045.

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