A Guide to Trusts

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Welcome to Succession Wealth

Our Wealth Planners are here to help you take control of your finances and provide you with the confidence you need to go after the things that matter to you.

Succession Wealth Management Limited is a large national independent financial planning firm operating in England and Scotland. Our teams of independent Wealth Planners deliver high-quality advice to thousands of clients throughout the UK, and we're committed to helping people achieve more with their money.

Our clients are at the heart of everything we do and looking after their wealth journey is a privilege to us. The relationships we build last longer than a lifetime, and we are proud to provide advice across generations. When you choose to work with us, we promise to provide an exceptional personal service tailored to your unique financial aspirations.

This guide has been created to provide a high-level overview of trusts and may be useful in helping you understand the basics of how they work and deciding if a trust may be beneficial to you.

What is a Trust?

Appropriate trusts can be used for minimising or mitigating Inheritance Tax (IHT) estate taxes and may offer other benefits as part of an integrated and coordinated approach to managing wealth. A trust is a fiduciary arrangement that allows a third-party, or trustee, to hold assets on behalf of a beneficiary or beneficiaries. Once the trust has been created, a person can use it to 'ring-fence' assets.

Trust terms:

Settlor — the person setting up the trust.

Trustees — the people tasked with looking after the trust and paying out its assets.

Beneficiaries — the people who benefit from the assets held in trust.

Bare Trust

Simplest form of Trust
Bare trusts are also known as 'absolute' or 'fixed interest' trusts, and there can be subtle differences. The settlor – the person creating the trust – makes a gift into the trust which is held for the benefit of a specified beneficiary. If the trust is for more than one beneficiary, each person's share of the trust fund must be specified. For lump sum investments, after allowing for any available annual exemptions, the balance of the gift is a potentially exempt transfer for IHT purposes. As long as the settlor survives for seven years from the date of the gift, it falls outside their estate.

The trust fund falls into the beneficiary's IHT estate from the date of the initial gift. With loan trusts, there isn't any initial gift – the trust is created with a loan instead.

Normal expenditure out of income exemption
When family protection policies are set up in bare trusts, regular premiums are usually exempt transfers for IHT purposes. The normal expenditure out of income exemption often applies, as long as the cost of the premiums can be covered out of the settlor's excess income in the same tax year, without affecting their normal standard of living.

Where this isn't possible, the annual exemption often covers some or all of the premiums. Any premiums that are non-exempt transfers into the trust are potentially exempt transfers. Special valuation rules apply when existing life policies are assigned into family trusts. The transfer of value for IHT purposes is treated as the greater of the open market value and the value of the premiums paid up to the date the policy is transferred into trust.

No ongoing Inheritance Tax reporting requirements or further Inheritance Tax implications
With a bare trust, there are no ongoing IHT reporting requirements and no further IHT implications. With protection policies, this applies whether or not the policy can acquire a surrender value. Where the trust holds a lump sum investment, the tax on any income and gains usually falls on the beneficiaries. The most common exception is where a parent has made a gift into trust for their minor child or stepchild, where parental settlement rules apply to the Income Tax treatment.

Trustees look after the Trust property for the known beneficiaries
Therefore, the trust administration is relatively straightforward, even for lump sum investments. Where relevant, the trustees simply need to choose appropriate investments and review these regularly.

With a bare trust, the trustees look after the trust property for the known beneficiaries, who become absolutely entitled to it at age 18 (age 16 in Scotland). Once a gift is made or a protection trust set up, the beneficiaries can't be changed, and money can't be withheld from them beyond the age of entitlement. This aspect may make them inappropriate to many clients who'd prefer to retain a greater degree of control.

Securing the settlor's right to receive their fixed payments
With a loan trust, this means repaying any outstanding loan. With a discounted gift trust, it means securing the settlor's right to receive their fixed payments for the rest of their life. With protection policies in bare trusts, any policy proceeds that haven't been carved out for the life assured's benefit under a split trust must be paid to the trust beneficiary if they're an adult. Where the beneficiary is a minor, the trustees must use the trust fund for their benefit.

Difficulties can arise if it's discovered that a trust beneficiary has predeceased the life assured. In this case, the proceeds belong to the legatees of the deceased beneficiary's estate, which can leave the trustees with the task of tracing them. The fact that beneficiaries are absolutely entitled to the funds also means the trust offers no protection of the funds from third-parties, for example, in the event of a beneficiary's divorce or bankruptcy.

Discretionary Trust

Settled or relevant property
With a discretionary trust, the settlor makes a gift into trust, and the trustees hold the trust fund for a wide class of potential beneficiaries. This is known as 'settled' or 'relevant' property. For lump sum investments, the initial gift is a chargeable lifetime transfer for IHT purposes. It's possible to use any available annual exemptions. If the total non-exempt amount gifted is greater than the settlor's available nil-rate band, there's an immediate IHT charge at the 20% lifetime rate – or effectively 25% if the settlor pays the tax.

The settlor's available nil-rate band is essentially the current nil-rate band less any chargeable lifetime transfers they've made in the previous seven years. So in many cases where no other planning is in place, this will simply be the current nil-rate band, which is £325,000 for 2022/23. The residence nil-rate band isn't available to trusts or any lifetime gifting.

Special valuation rules for existing policies assigned into trust
Again, there's no initial gift when setting up a loan trust, and the initial gift is usually discounted when setting up a discounted gift plan. Where a cash gift exceeds the available nil-rate band, or an asset is gifted which exceeds 80% of the nil-rate band, the gift must be reported to HM Revenue & Customs (HMRC) on an IHT 100. When family protection policies are set up in discretionary trusts, regular premiums are usually exempt transfers for IHT purposes. Any premiums that are non-exempt transfers into the trust will be chargeable lifetime transfers. Special valuation rules for existing policies assigned into trust apply.

Value of the trust fund will be the open market value of the policy
As well as the potential for an immediate IHT charge on the creation of the trust, there are two other points at which IHT charges will apply. These are known as 'periodic charges' and 'exit charges'. Periodic charges apply at every ten-yearly anniversary of the creation of the trust. Exit charges may apply when funds leave the trust. The calculations can be complex but are a maximum of 6% of the value of the trust fund. In many cases, they'll be considerably less than this – in simple terms, the 6% is applied on the value in excess of the trust's available nil-rate band.

However, even where there is little or, in some circumstances, no tax to pay, the trustees still need to submit an IHT 100 to HMRC. Under current legislation, HMRC will do any calculations required on request. For a gift trust holding an investment bond, the value of the trust fund will be the open market value of the policy – normally its surrender value. For a loan trust, the value of the trust fund is the bond value less the amount of any outstanding loan still repayable on demand to the settlor. Retained rights can be recalculated as if the settlor was ten years older.

For discounted gift schemes, the value of the trust fund normally excludes the value of the settlor's retained rights – and in most cases, HMRC are willing to accept pragmatic valuations. For example, where the settlor was fully underwritten at the outset, and is not terminally ill at a ten-yearly anniversary, any initial discount taking account of the value of the settlor's retained rights can be recalculated as if the settlor was ten years older than at the outset.

If a protection policy with no surrender value is held in a discretionary trust, there will usually be no periodic charges at each ten-yearly anniversary. However, a charge could apply if a claim has been paid out and the funds are still in the trust. In addition, if a life assured is in severe ill health around a ten-yearly anniversary, the policy could have an open market value close to the claim value. If so, this has to be considered when calculating any periodic charge.

Discretionary Trust

Investing in life assurance investment bonds could avoid complications
Where discretionary trusts hold investments, the tax on income and gains can also be complex, particularly where income-producing assets are used. Where appropriate, some of these complications could be avoided by an individual investing in life assurance investment bonds, as these are non-income producing assets and allow trustees to control the tax points on any chargeable event gains.

Discretionary trusts give the trustees discretion over who benefits and when. The trust deed will set out all the potential beneficiaries, and these usually include a wide range of family members, plus any other individuals the settlor has chosen. This gives the trustees a high degree of control over the funds. The settlor is often also a trustee to help ensure their wishes are considered during their lifetime.

Powers depend on the trust provisions, but usually include some degree of veto
In addition, the settlor can provide the trustees with a letter of wishes identifying who they'd like to benefit and when. The letter isn't legally binding but can give the trustees clear guidance, which can be amended if circumstances change. The settlor might also be able to appoint a protector, whose powers depend on the trust provisions, but usually include some degree of veto.

Family disputes are not uncommon, and many feel they'd prefer to pass funds down the generations when the beneficiaries are slightly older than age 18. A discretionary trust also provides greater protection from third parties, for example, in the event of a potential beneficiary's divorce or bankruptcy, although in recent years this has come under greater challenge.

Flexible Trusts with default beneficiaries

At least one named default beneficiary
These are similar to a fully discretionary trust, except that alongside a wide class of potential beneficiaries, there must be at least one named default beneficiary. Flexible trusts with default beneficiaries set up in the settlor's lifetime from 22 March 2006 onwards are treated in exactly the same way as discretionary trusts for IHT purposes. Different IHT rules apply to older trusts set up by 21 March 2006 that meet specified criteria, and some Will trusts.

All post–21 March 2006 lifetime trusts of this type are taxed in the same way as fully discretionary trusts for IHT and Capital Gains Tax purposes. For Income Tax purposes, any income is payable to and taxable on the default beneficiary. However, this doesn't apply to even regular withdrawals from investment bonds, which are non-income producing assets. Bond withdrawals are capital payments, even though chargeable event gains are subject to Income Tax. As with bare trusts, the parental settlement rules apply if parents make gifts into trust for their minor children or stepchildren.

When it comes to beneficiaries and control, there are no significant differences between fully discretionary trusts and this type of trust. There will be a wide range of potential beneficiaries. In addition, there will be one or more named default beneficiaries. Naming a default beneficiary is no more binding on the trustees than providing a letter of wishes setting out whom the settlor would like to benefit from the trust fund.

The trustees still have discretion over which of the default and potential beneficiaries actually benefits and when. Some older flexible trusts limit the trustees' discretionary powers to within two years of the settlor's death, but this is no longer a common feature of this type of trust.

Split Trusts

Family protection policies
These trusts are often used for family protection policies with critical illness or terminal illness benefits in addition to life cover. Split trusts can be bare trusts, discretionary trusts, or flexible trusts with default beneficiaries. When using this type of trust, the settlor/life assured carves out the right to receive any critical illness or terminal illness benefit from the outset, so there aren't any gift with reservation issues.

In the event of a claim, the provider normally pays any policy benefits to the trustees, who must then pay any carved-out entitlements to the life assured and use any other proceeds to benefit the trust beneficiaries.

If terminal illness benefit is carved out, this could result in the payment ending up back in the life assured's IHT estate before their death. A carved-out terminal illness benefit is treated as falling into their IHT estate once they meet the conditions for payment.

Trade-off between simplicity and the degree of control
Essentially, these types of trust offer a trade-off between simplicity and the degree of control available to the settlor and their chosen trustees. For most, control is the more significant aspect, especially where any lump sum gifts can stay within a settlor's available IHT nil-rate band. Keeping gifts within the nil-rate band and using non-income producing assets such as investment bonds can allow a settlor to create a trust with maximum control, no initial IHT charge and limited ongoing administrative or tax burdens.

In other cases, for example, grandparents funding for school fees, the bare trust may offer advantages. This is because tax will fall on the grandchildren, and most of the funds may be used up by the age of 18. The considerations are slightly different when considering family protection policies, where the settlor will often be dead when policy proceeds are paid out to beneficiaries.

A bare trust ensures the policy proceeds will be payable to one or more individuals, with no uncertainty about whether the trustees will follow the deceased's wishes. However, this can also mean that the only solution to a change in circumstances, such as divorce from the intended beneficiary, is to start again with a new policy. Settlors are often excluded from benefiting under discretionary and flexible trusts. Where this applies, this type of trust isn't suitable for use with joint life, first death protection policies if the primary purpose is for the proceeds to go to the survivor.

New Legislation for registering a Trust
Legislation has been introduced that extends the scope of trust registration. Registration was previously only required for certain trusts that became liable to UK tax, now most UK trusts must be registered whether liable for tax for not. There are some trusts that are excluded from registering and you can check the full list of excluded trusts on the gov.uk website.

It is the responsibilities of trustees to register before the deadline (the deadline is dependent on when the trust was created, whether it is taxable or not and if the trust is already registered for Self –Assessment (SA) for Income Tax or Capital Gains Tax (CGT)), through the HMRC Trust Registration Service (TRS), either by the nominated 'lead trustee' or a registered agent acting on the trust's behalf. There will also be a requirement for the register to be updated annually. HMRC may issue a payment penalty if the trust has failed to register or submit an annual declaration by the deadline.

Contact us

If you would like to discuss this, or any aspect of financial advice with one of our Wealth Planners, feel free to email us at hello@successionwealth.co.uk or call us on 0800 051 4659 and we will arrange for someone to contact you.

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Important Information