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Peace of mind from Pearson Hinchliffe



A GUIDE TO TRUSTS

Peace of mind from Pearson Hinchliffe

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INTRODUCTION

What is a trust?

In simple terms a trust is where property is held by trustees (called "**Trustees**") on behalf of other people. The person who creates the trust is called "**the Settlor**" and he or she specifies the people for whom the property is to be held. They are called "**Beneficiaries.**"

Why create a trust?

Trusts are created for many reasons:

- ◆ For disabled beneficiaries or minors who are not able to deal with their own property.
- ◆ For beneficiaries whom the Settlor believes would otherwise dissipate the money or property.
- ◆ To provide for a widow or widower for his or her lifetime but specifying the property then passes to the Settlor's children.
- ◆ The Settlor wants to give property away but wants to remain in control. However, unless the Settlor and his or her spouse are excluded from benefiting from the trust he will be treated for tax purposes as still owning the assets. For example if the Settlor gives away a house but continues to live in it, or receives income from cash or property which has been given away.
- ◆ To avoid unacceptable laws or restrictions.
- ◆ To avoid loss of benefits.
- ◆ To avoid tax.

What taxes might be payable?

Subject to various exemptions and reliefs **Inheritance tax (IHT)** is payable on death or on a lifetime gift exceeding a value set in the budget each year. From 6 April 2003 this is £255000 per person. This is called the "**Nil Rate Band.**"

Any gifts between spouses or to charity are completely exempt.

Any gifts made more than 7 years before death are exempt, provided no benefit has been reserved as mentioned above. These are called "**Potentially Exempt Transfers or PET's.**"

Capital Gains tax (CGT) is payable on a disposal of an asset, whether by sale or gift, if the value of the asset has increased during the ownership of the person selling or giving it. Again there are exemptions and allowances set by the budget each year. CGT is never payable on a disposal which would be subject to IHT.

Income tax is payable on income earned on moneys held in a trust. With some types of trust a higher trust income tax rate is payable. It is therefore necessary to consider whether or not the trust assets will produce income when deciding which type of trust to use.

What are the powers of Trustees?

Subject to compliance with the statutory duty of care, Trustees may make any kind of investment, as if they are absolutely entitled to the assets of the trust. This can be restricted by the Settlor, for example if the Trust Deed prohibits certain investments.

Trustees will need to be given additional powers if the trust property will consist of private company shares or if the Trustees are to carry on a business or borrow money on the security of trust property.

How do I set up a Trust?

Contact **John Pearson** at

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Or telephone **0161 785 3500.**

Please note that this is a brief guide to trusts. It is important to seek the advice of your solicitor as each person's circumstances are different. The information in this guide is based upon the 2003 Budget and may be subject to amendment.

The advantage is that the decision can be made within two years from death, with full knowledge of all the facts, as opposed to having to reach a decision now, when we do not know when the testator will die nor the financial circumstances which will apply at that time.

Thus, a discretionary trust retains the option of saving tax. There is a requirement to file tax returns for the trust during its administration and so fees will be incurred in this respect. Other than this, there are no adverse consequences.

TRUSTEES' DUTIES AND POWERS

Who should act as Trustees?

This is a very personal decision for the Settlor. The Trustees must honour various duties but have wide powers. The Settlor must be satisfied that the Trustees chosen will be able to fulfil those responsibilities and will act on the Settlor's wishes. This is particularly important where, for example, the beneficiary may be the widow or widower of the Settlor and there may be a conflict of interest between the surviving spouse and the children of the Settlor.

It is normal to consider a solicitor or accountant to act as a trustee, sometimes jointly with a family member.

It is advisable for the Settlor to write a letter to the Trustees setting out his or her wishes as to how the trust is to be administered in any given situation.

What are the duties of Trustees?

The Trustee must:-

Exercise reasonable and proper care in relation to the management of trust assets.

Acquire knowledge about the trust property and the nature of the trust provisions.

Obey the directions of the Trust Deed.

Act impartially.

Invest in accordance with the Trust deed

Act jointly. All trustees must act in unison. It is not permissible for a majority view to prevail unless so specified in the Trust Deed.

Not receive reward for acting as trustee unless authorised by the Trust Deed.

What types of trust are there?

Different kinds of trust are used to suit each situation, as explained below. This will depend on the wishes of the Settlor and the relevant tax considerations.

INTEREST IN POSSESSION TRUSTS

What is an Interest in Possession trust?

Where a Beneficiary is entitled to immediate enjoyment of a right to trust property.

The basic structure is the payment of income as it arises to a Beneficiary (called "**the Life Tenant**") during his or her lifetime, followed by a gift to other Beneficiaries on the death of the Life Tenant. E.g. "the income from my property to my wife for her life and then the capital to my children."

It is usual to include other powers for the Trustees, for example:-

To revoke the right of the Life Tenant to any income and pay it instead to another Beneficiary.

To transfer capital to the Life Tenant.

What are the tax implications?

If made during the lifetime of the Settlor the gift to the trust will be a PET. There will be no IHT provided the Settlor survives 7 years. If the survivor dies during the 7 years the amount of tax is reduced by "Taper Relief." The value of the trust property will be aggregated with the estate of the Life Tenant on his or her death.

If on death it will depend on whether the value of the estate is taxable or if, for example, the spouse exemption applies.

BARE TRUSTS

What is a Bare trust?

Where the Trustee merely holds all income and capital for a Beneficiary absolutely. It belongs to the Beneficiary for tax purposes.

DISCRETIONARY TRUSTS

What is a Discretionary trust?

The Trustees have a discretion over the distribution or accumulation of income and appointment of capital out of the trust. No Beneficiary has any right to require the Trustees to exercise their discretion in his or her favour.

When is this used?

Nil Rate Band Discretionary trusts in Wills, as mentioned below.

Lifetime gifts with an initial value within the Nil Rate Band where hold over relief is required for CGT purposes i.e. gifts of non-business assets. This can be useful for gifts of second homes.

Trusts to hold benefits of insurance policies or pension plans.

Trusts to avoid assessment for loss of benefits.

What are the tax implications?

Income Tax is charged in the trust's hands at 34%.

There is a reduced allowance from CGT

There is a 10 yearly periodic charge for IHT and potentially an exit charge when property leaves the trust.

The gift to the trust is not a PET and IHT will be payable if the value of the gift exceeds the Nil Rate Band.

Hold over relief from CGT is available.

ACCUMULATION AND MAINTENANCE TRUSTS

What is an Accumulation and Maintenance trust?

A special form of Discretionary trust which, provided certain rules are met, has tax advantages in that it is as flexible as a Discretionary trust but does not have some of the tax disadvantages of a Discretionary trust.

When is this used?

In practice they are used when grandparents wish to benefit grandchildren. The main advantages are:

They are treated as a PET by the Settlor when made during his or her lifetime.

There are no 10 yearly periodic charges unlike ordinary Discretionary trusts.

There are no exit charges for IHT provided certain conditions are met.

DISABLED TRUSTS

When is this used?

The Beneficiary must be mentally or physically disabled at the time of the gift to the trust. It has tax advantages, provided certain rules are met, in that it is as flexible as a Discretionary trust but does not have some of the tax disadvantages of a Discretionary trust.

NIL RATE BAND DISCRETIONARY WILL TRUSTS

Any gifts between spouses, whether during their lifetime or on death, are exempt from IHT. In addition, every person may give up to £255,000 to other people free of IHT.

Take the example of a couple who have assets worth £510,000. In their wills they each leave all their estate to the survivor. There will be no tax on the first death as the gift between spouses is exempt. However, on the second death only £255,000 will be free of tax and tax will become payable at 40% on the remaining £255,000.

Suppose, however, they had separated their assets - so that each of Mr. A. and Mrs. A. had £255,000 worth of assets in their respective sole names. In their wills, they could leave £255,000 to, say, their children instead of their spouse. This sum would be free of tax. There would be no tax payable on either death - a saving of 40% of £255,000. It is, however, important that the assets are held individually. If they are in joint names they will pass automatically to the survivor and will not pass under the will, thus defeating the object of the exercise.

The obvious drawback to these arrangements is that the surviving spouse may not be able to manage on their own assets, which now total only £255,000. At the time of making the will, we do not know when it will come into effect, nor the financial position of the surviving spouse upon the death of the other spouse. It is, however, possible for each spouse to leave whatever the tax free sum may be on their death into a discretionary trust. The potential beneficiaries of the trust could be the surviving spouse, children, grandchildren and any other people the Settlor may desire. The surviving spouse, as one of the trustees of the trust, is given up to two years from the death of their spouse to decide whether he or she can afford to pass to the other potential beneficiaries any part of the trust fund.

If he or she decides to pass over the whole of the £255,000, that will be free of any tax. If it is decided that all the fund is required by the survivor, no tax will be payable as an exempt gift. Tax would, of course, become payable on the second death. However, it is possible to give the trustees of the trust fund power to transfer property to the survivor but accept a promise that the survivor will repay a loan to the trust fund for the amount transferred. This retains the option of saving tax.