Brian Courtney

TRUST TAXATION MANUAL

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Preface

This is a book for the accountant in general practice and those in a similar position – not for the tax expert. The general practitioner is the central character in the field of personal financial planning, and too often he ignores the important place that trusts can play in his work because of the taxation complexities and pitfalls that he knows can be involved.

Nevertheless there is no reason why he should not know enough about trust taxation to enable him to make full use of this important tool in the service that he gives his clients.

And that is what this book seeks to do – to provide the accountant with sufficient practical guidance to enable him to give trusts their proper place in his financial planning service; and that not only covers the questions of what type of trust to set up and when, but the continuing problems of the trusts' investments and management generally. None of these questions can be answered without first considering the taxation consequences. The accountant who cannot confidently make use of trusts deprives the clients of many opportunities to plan their financial affairs to better advantage.

All the tax rates, allowances and exemptions used are those applying in 1986/87. The law is that applying at 1 August 1986.

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Abbreviations

CGT	Capital gains tax
CGTA 1979	Capital Gains Tax Act 1979
FA (year)	Finance Act (year)
IHT	Inheritance tax
IHTA 1984	Inheritance Tax Act 1984
PET	Provisionally exempt transfer
PETA	Pure endowment and a term assurance plan
TA 1970	Income and Corporation Taxes Act 1970
TIA 1961	Trustee Investment Act 1961
TMA 1970	Taxes Management Act 1970
USM	Unlisted Securities Market

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1.1 WHAT IS A TRUST?

1.1:1 A trust exists where the legal and equitable interests in property are separated. The settlor gives the legal interest to the trustees and the equitable interest to beneficiaries. The three parties are not mutually exclusive – the settlor may also be a trustee or a beneficiary – a beneficiary may be a trustee – but their roles are distinct. Beneficiaries need not be individuals – they may, for example, be animals or charities.

1.1:2 A trust can be created in many ways. Where an agreement fails there may be an *implied trust* to hold property or funds for the benefit of the original owner. Where property is purchased by one person in the name of another there may be *an implied and resulting* trust in favour of the purchaser. Where a trust fails due to uncertainty or impossibility or illegality there may be a *resulting trust* in favour of the settlor. Where a trustee makes a profit there may be a *constructive trust* in favour of his beneficiary. A person knowingly receiving trust property becomes a constructive trustee of that property.

The more normal *express trust* can even be set up verbally provided the terms are clear.

1.1:3 However, the wise financial advisor will not rely on any of the above legal rules. He will make sure that a proper deed of trust is drawn up, and that the deed sets out clearly what is to be held and by whom it is to be held and for whose benefit it is to be held and on what terms and conditions.

1.1:4 He will also make sure that the subject matter of the trust is legally transferred to the trustees, and this may require a document in addition to the trust deed. If it is land, a legal conveyance is required; if it is shares a form of share transfer is required; if chattels an act of delivery and so on. In most cases the trust will not be enforceable until this is done, although the courts will enforce a trust if the settlor has done all that he can to vest the property but some other party is at fault.

If exceptionally the settlor is to be the sole trustee, the assets will already be vested in him and a declaration in the trust deed is all that is required.

1.1:5 For the trust deed itself to be valid it must contain the 'three certainties' laid down in *Knight v Knight* (1840) 3 Beau 148.

(a) *Certainty of words* It must be clear that the settlor intended to

create a trust. An expressed hope or desire is not enough.
(b) *Certainty of the subject matter* It must be clear what assets are being settled and what interests are being created in those assets.
(c) *Certainty of the objects* There must be beneficiaries who could enforce the trust and it must be clear who they are. A charitable trust is exceptional in that it need not be enforceable by beneficiaries.

1.1:6 A trust is distinguished from other similar legal concepts as follows:
(a) *An agency* will come to an end when the agent dies or resigns and the agent has no legal title to assets.
(b) *A bailment* also does not pass the title in the assets to the bailee and he is bound to return them to the bailor in due course.
(c) *A contract* gives valuable consideration while a trustee cannot benefit from his position. There is no third party to enforce a contract (ie no beneficiary).
(d) *A power of appointment* need not be exercised while a trustee must exercise his duties.

1.1:7 Any person who can own and dispose of an asset can create a valid trust of that asset. But it should be noted that:
(a) A trust created by a minor can be set aside by him when he comes of age.
(b) A trust created by a mentally disabled person can be set aside if the court is satisfied that he did not know what he was doing.

1.2 WHY SET UP A TRUST?

1.2:1 Trusts may be set up for reasons which have little or nothing to do with taxation – for example:
(a) To hold property for minors.
(b) To enable a beneficiary to enjoy the income but to have no recourse to the capital.
(c) To preserve capital for the next generation.
(d) To provide flexibility regarding future needs or contingencies.
(e) To protect capital in the event of the beneficiary's financial difficulty or bankruptcy.
(f) To hold funds for a (mentally) disabled person.
(g) To hold shares for employees.
(h) To hold funds for charitable purposes, or for pensions, or for historic buildings.

1.2:2 While the above are not basically tax-saving purposes, those under (e) to (h) are given special tax exemptions.

1.2:3 On the other hand many trusts are formed primarily for tax-saving reasons – in cases where the settlor will not or cannot make an absolute gift. The most common reasons are to take the income out of the settlor's higher rates of income tax or to take the capital out of the settlor's estate for IHT. Other tax objectives and how to use trusts in their achievement are set out in Chapter 7.

1.3 LEGAL RESTRICTIONS

There are rules which trusts must observe if they are not to be void or voidable – in general terms they must not be illegal, immoral or contrary to public policy. The main specific rules are set out in the following paragraphs.

1.3:1 The rule against perpetuities

The settlor cannot make his trust last indefinitely – within a limited time the assets must come into the beneficial ownership of a person who can dispose of them.

The trust deed (or will) can specify any period before the vesting provided it is less than 80 years. Failing such a provision in the deed the period is the lifetime of a person conceived before the date of the deed (or the date of death) plus 21 years. When the trust is set up it may not be clear whether the vesting date will obey this second rule, but if it is possible that it may do so, then the trustees may await the outcome.

If the time limit expires before the vesting or if it becomes certain that it will do so, the assets revert to the settlor.

1.3:2 Rules limiting accumulations

This is a different problem because a vesting may take place after a life interest rather than after a period of accumulation. The alternative limits to a period of accumulation are:
(a) The life of the settlor.
(b) Twenty-one years from the settlement date.
(c) The minority of any person conceived at the settlement date, whether a beneficiary or not.