

Trusts Explained



Many people, often without realising it, will come into contact at some point of their lives with a trust in one form or another. Yet trusts are widely misunderstood and often seen as something just the rich need be concerned with. This leaflet aims to give a quick overview of how trusts work, what they are most commonly used for and to correct some of the widespread misconceptions held about trusts. Trusts are found around the world, but particularly in those countries where the legal system has its roots in the English system. The exact technical details of trusts, how they are set up and how they are taxed vary from country to country, so this guide focuses only on some of the broad principles. If you need to know more you should contact a professional advisor.

What is a Trust?

Trusts are, in principle, a very simple concept. A trust is a private legal arrangement where the ownership of someone's assets (which might include property, shares or cash) is transferred to someone else (usually, in practice, not just one person, but a small group of people or a trust company) to look after and use to benefit a third person (or group of people).

The person giving the assets is usually known as the “settlor” in the UK or a “grantor” in the US (but can also sometimes be called the “trustor” or the “creator”). The people asked to look after the assets are called the “trustees” and the person who benefits from the trust is called the “beneficiary”. The details of the arrangement are usually laid out in a “trust deed” and the assets placed in the trust are the “trust fund”.

One common misconception is that the assets in the trust fund are legally owned by the trust. In fact, a trust, unlike a company, cannot own assets and instead the trustees are the legal owners of the assets. The distinctive feature of a trust is therefore the separation of legal ownership and beneficial ownership of the assets in the trust fund. The trustees are the legal owners of the assets, but the trustees must at all times put the interest of the beneficiaries above their own. Thus, the settlor of trust can be a trustee, but they must still act in the interests of the beneficiary, not themselves.



Trusts can take effect during the lifetime of the settlor (in which case in the UK they are called a “lifetime settlement”) or shortly after the death of the settlor (in which case in the UK they are called a “will trust”). There is also a wide-range of different types of trust depending, for example, on how the benefits of the trust fund are to be distributed. The basic principle that a trust contains assets owned by someone for the benefit of someone else nevertheless remains true in all forms of trust.

Why use a Trust?

Trusts are very common indeed and play a key role in many aspects of everyday life. In the UK, for example, most company pension schemes are structured as trusts, with the employer (who in this case is the settlor) giving cash to a pension fund manager (the trustee) to invest for the benefit of employees when they retire (the beneficiaries). The trust structure helps clarify the administration, regulation and taxation of the pension fund.

Similarly, many life insurance policies are “written in trust” so that when the person insured dies the policy pays out to a trust run by the insurer, which then pays the cash out in line with the insured person’s wishes. The trust structure both helps minimise inheritance taxes (see more on this in the section on trusts and taxes) and ensures that the deceased’s wishes about how the insurance funds are to be distributed can be followed quickly and accurately.

Trusts are also very commonly used for charitable funding (in the US foundations are also often used for similar purposes). In the UK, for example, the Wellcome Trust donates well over £300 million annually to medical research, but as well as the large, well-known charitable trusts, there are a wide-range of smaller trusts created to help fund a particular good cause. One of the great advantages of the trust

structure for charitable funding is that the person setting up the trust can simply indicate how they wish the funds to be used (for example, “for medical research”), but leave it to the trustees to decide over time which medical research projects should be funded. This highlights the benefit of the flexibility inherent in trust structures when someone is making long-term commitments.





For most people, however, the type of trust they are most likely to be asked to make decisions about personally is a trust established to arrange their family's financial affairs. In this context, the main attraction of trusts is that they give the settlor greater confidence in how assets will be used in the future. Put simply, trusts offer a means of holding and managing money or property for people who may not be ready or able to manage it for themselves. Indeed, trusts can be created to benefit people who are not even born yet – such as any future grandchildren someone may have.

Some of the most common family situations where trusts are used (often in conjunction with a will) are:

- To provide for a husband or wife after death while protecting the interests of any children
- To protect the inheritance of young children until they are old enough to take responsibility for their own efforts
- To provide for vulnerable relatives who are unlikely to be able to look after their own affairs
- To help succession planning in family businesses.

It is clear that trusts are particularly useful when planning how money and assets should pass from one generation to another, especially when family structures are complicated by divorces and second marriages. This, coupled with the growing frequency of marriage breakdowns, may explain the huge increase in popularity of trusts in many countries. In the US, for example, the number of domestic trusts filing for tax each year has doubled since the mid 1970s. In 2003, 3.6 million US domestic trusts were filed for tax purposes and they are now the third most common form of filing in the US tax system. By 2015, the US Internal Revenue Service estimates that \$4.8 trillion in wealth will be inherited or transferred from one generation, with much of it transferred through trusts.

Are Trusts Secret?

Trusts are private arrangements, often laying out how a family's savings are to be distributed within the family. Most people setting up such arrangements would expect them to be kept private. Quite often, even the beneficiaries of a trust will not know about the trust, possibly because a parent would prefer their children not to know that they are likely at some point to receive benefits from the trust. Another common issue is that there may be beneficiaries who, in practice, will only receive any funds from a trust in the most extreme circumstances – such as when all closer relatives have predeceased them.

Trusts, like bank accounts and most other family financial affairs, are therefore generally regarded as confidential. Most people would find it



intrusive if they had to publicly register their credit card accounts and report whether they were in joint names with their husband or wife. Recognising this, in most countries where trusts are common there is no requirement to register a trust. Nor is there any requirement to publish details such as who the settlor, trustees or beneficiaries are or how much the fund is worth. Even so, in most of the major economies trustees do have to inform the tax authorities when a trust is set up.

Most countries also have strictly enforced regulations requiring the trustees to establish the identities of the settlor and beneficiaries and to provide this information to the authorities if the authorities believe the trust is being used for illegal purposes. Trustees also generally have a duty to report suspicious activity to the authorities. Thus, while trusts are confidential, it would be wrong to regard them as “secret”. Generally, trusts are no more or less “secret” than bank accounts.

The legitimacy of someone wishing to keep their family financial affairs confidential is recognised by most governments in the developed world. Respecting personal confidentiality is generally regarded as an essential part of good tax governance. The Organisation for Economic Co-operation and Development (OECD), for example, has stated that “the obligation to keep taxpayer information confidential and only release it in accordance with the law is a fundamental principle” (*Engaging with High Net Worth Individuals on Tax Compliance*, OECD, May 2009, pg 53).

Trusts and Tax

Trusts are occasionally represented by some commentators as just devices to avoid tax. In reality, there are virtually no circumstances in which anyone would be well-advised to set up a trust just to gain tax advantages. In setting up a trust, the settlor is giving up ownership of the assets in the trust. Such a dramatic move will normally only make sense if the settlor has clear objectives that they wish to achieve with those assets, and tax is likely to be a secondary issue.

In most countries, any tax advantages given to trusts are, in any case, tightly targeted by the tax authorities at trusts that are seen as doing a social good. Charitable trusts are an obvious example, but trusts set up to look after vulnerable or disabled relatives also often attract some tax advantages. Another example is the favourable treatment the Canadian authorities give to immigrant trusts. It goes without saying that there are quite strict rules about the sorts of trusts that attract significant tax advantages and the tax authorities tend to police those rules closely.

Most other trusts attract relatively few tax advantages. In the UK, for example, the official position is to pursue a policy of being tax neutral towards most trusts, so that the tax system neither encourages nor discourages anyone from setting up a trust (although, in practice, most professional advisors think the UK tax system now actively penalises some types of trust). In line with this policy of fiscal neutrality, the



trustees must give the UK tax authorities full details when a trust is established and are generally personally liable for taxes due on the trust. Similarly, in the US, the declared intent of the Inland Revenue Service (IRS) is that there should be no income tax advantage to trusts and there are onerous trust reporting requirements.

International Trends in Trusts

It is clear that tax will rarely be the main reason for setting up a trust. The key attractions are, instead, the ability of trusts to ensure that assets will ultimately be used in a certain way while allowing flexibility in how those assets are managed before they are distributed. That flexibility is particularly useful in an international context. For example, the International Monetary Fund (IMF) has established a trust to channel donor funding to finance technical assistance in its Anti-Money Laundering and Combating the Financing of Terrorism programmes. Indeed, this trust fund is expected to be the first of a series of “Topical Trust Funds” established to channel multi-donor funding to key IMF programmes.

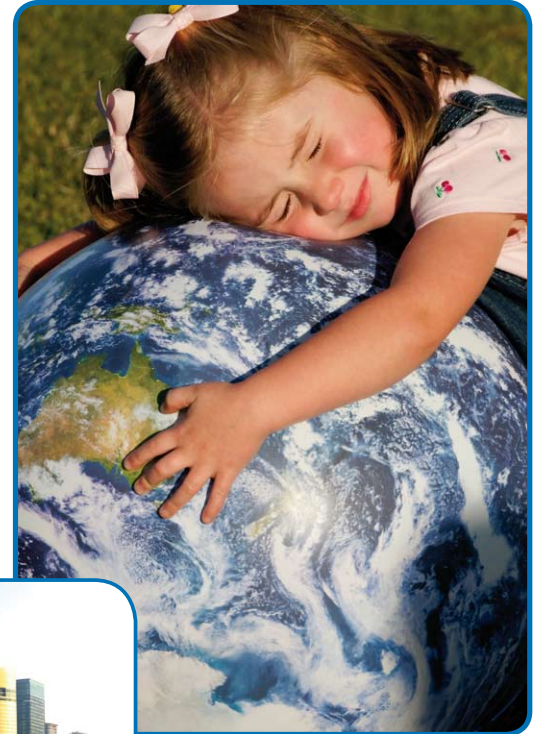
Families are similarly attracted by the flexibility of trust structures to cope with a wide-range of family circumstances, and this flexibility becomes particularly important when a family, or its business interests, are scattered across a range of different countries, each with its own inheritance, tax and business laws. Thus, one of the key developments that many professional advisors have noted has been the growth in demand for advice by geographically widely based families over the past few years, with the fall of the Iron Curtain and the spectacular rise in economies such as India and China being major factors here.

Advisors to geographically diverse families will normally recommend a trust structure based in one of the major international financial centres. These centres typically offer a strong legal and regulatory framework, an efficient banking system, a wide pool of professional expertise in relevant areas and a tax-neutral environment for trusts and international investors. London and New York have long played pre-eminent roles in this context and they still have dominant positions as international financial centres. In recent years, however, there has also been rapid



growth in many other international financial centres, including relatively new centres such as some of the Caribbean jurisdictions, as well as long-established banking centres such as Switzerland.

The rapid growth in these centres has led to significant pressure from bodies such as the OECD and G20 to regularise their position in the international tax system relative to the major economies. This has further highlighted the role of professional advisors in international centres helping ensure their clients are tax compliant in a range of different jurisdictions.



The Future

Few areas of activity have emerged unscathed from the recent worldwide turmoil in the banking system and the consequent weakness in financial markets. Consumer confidence around the world has been battered and the valuation of family assets has been under pressure. All these factors might well be expected to deter people from setting up trusts. In reality, the indications are that trusts are still widely seen as a useful way to plan for the long-term future. Generally, the evidence suggests that trusts continue to grow in popularity.

In many developed countries major pressures on public spending are translating into doubts about social welfare programmes. In these circumstances, the role trusts can play in helping underpin the future of vulnerable family members is gaining fresh importance. Similarly, the extreme economic turbulence of the recent past has



demonstrated to many the merits of diversifying how assets are held internationally and the role trusts can play here is widely recognised.

The major threats to trust growth instead come from changes in the tax system. While most of the major jurisdictions where trusts are common have a stated policy of being tax-neutral with respect to trusts, in some countries, most notably the UK, the tax system has, in practice, begun to tilt against trusts – often it seems unintentionally. While tax advantage is seldom the prime motivator behind someone setting up a trust, tax penalties on setting up a trust can be a powerful deterrent and the formation of some types of family trust has declined rapidly in the UK.

Most of the developed world is nevertheless adapting to the needs of ageing populations. Families are frequently concerned about ensuring that the interests of an ageing parent or grandparent are protected during a period of their lives when the ability to make important decisions may become clouded. A generation that has often managed to accumulate significant assets over its lifetime is also naturally concerned about how those assets will be passed on to future generations. These are all precisely the sorts of issues trusts were developed to address. Professional advisors remain confident that trusts will continue to provide popular, practical solutions to problems in ordinary people's lives.

What is STEP?

The Society of Trust and Estate Practitioners (STEP) is the worldwide professional body for practitioners in the fields of trusts and estates, executorship and related issues. STEP aims to promote the highest professional standards through education and training leading to widely recognised and respected professional qualifications. STEP also works to demonstrate the value of good stewardship and planning across future generations to governments, professionals, financial institutions and the public. STEP internationally has more than 14,000 members, and more than 4,000 students worldwide are currently studying for STEP qualifications.

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