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Guide to trusts

Introduction

This booklet is intended as a practical guide for advisers. We offer a range of draft trust deeds across the Nucleus group proposition, some of which are detailed later in this guide. The trusts have differing Inheritance Tax (IHT) consequences and it is important to fully understand these. Clients should seek legal and tax advice before establishing any trust to ensure it meets their needs and requirements.

Features

- Trust fundamentals
- Inheritance tax treatment of trusts
- Common types of trusts

Trust fundamentals

What is a trust?

There are three parties to a trust arrangement:

- settlor or donor
- trustees
- beneficiaries.

The person creating the trust, the settlor or donor gifts assets or cash to the trustees who will hold the assets for the benefit of the beneficiaries. The trustees look after the trust assets in accordance with the instructions given to them as per the trust deed. The trustees are also guided by overriding legal principles and legislation.

Trustees – appointments and duties

Trustees must be at least 18 years of age and of sound mind. Beyond that, as the name implies, trustees should principally be people whom the settlor feels can be trusted. The settlor can also be a trustee, which enables the settlor to retain some control over the trust assets. Additional trustees could include family friends, professional advisers or a trust corporation. Beneficiaries may also act as trustees, although care should be exercised to avoid any conflicts of interest.

It is important that the trustees understand their role as directed by the trust deed and trust law. Trustees have a statutory duty of care when carrying out their duties, as well as a duty to act in the best interests of the beneficiaries.

Choice of trust – bare/absolute, interest in possession or discretionary

Clients can establish their trusts on either an bare or absolute basis, interest in possession or discretionary basis but settlors and their trustees should seek legal, tax and financial advice to ensure the trust is suitable for their objectives and understand the creation, management and taxation regimes for each of these types of trust.

Beneficiaries of a bare trust

Beneficiaries are named and their shares defined from the outset of the trust. They are absolutely entitled to the trust property and any income produced from it. The trustees of a bare trust cannot change the beneficiaries' entitlement in any way. If the named beneficiary dies, the value of the trust property will form part of their IHT estate and their will or the laws of intestacy will determine who inherits the trust property. The trustees have no discretion over this.

It is therefore important to choose beneficiaries of bare trusts very carefully.

Beneficiaries of an interest in possession (IIP) trust

There are usually two classes of beneficiaries under a IIP trust, the life tenant, who has absolute right to income produced from the assets within the trusts or to reside in a property for example rent free for their lifetime. The other class of beneficiaries are known as the 'remaindermen' who have rights to capital after death of life tenant or if they give up their rights during their lifetime.

Income can be mandated to beneficiary rather than via trustees, which means the rate of income tax is correct for the life tenant and can reduce administration for trustees and beneficiary.

Beneficiaries of a discretionary trust

These beneficiaries only benefit at the trustees' discretion. No beneficiary has a right to trust income or capital. Instead, the trustees hold the trust fund on behalf of a range of potential beneficiaries, such as the settlor's spouse, children, grandchildren, etc. The trustees have complete discretion over who gets what and when from the trust. Accordingly, while the assets remain part of the trust, the value will not form part of any beneficiary's estate. This can be important for IHT and long term care purposes.

Inheritance tax treatment of bare/absolute, interest in possession and discretionary trusts

Bare/absolute trusts

Gifting an asset to a bare or absolute trust will be a potentially exempt transfer (PET) for IHT purposes. Regardless of the value of the gift, no immediate IHT will arise upon making the gift and if the donor survives for seven years after making the gift, it will be outside the estate for IHT purposes.

As the beneficiaries of a bare trust have absolute entitlement to the trust assets, the value of the trust fund will form part of the named beneficiary's IHT estate.

Exceptions to this IHT treatment include where a probate trust or a loan trust is set up.

When a probate trust is set up, the donor or settlor retains complete access to the trust fund during their lifetime. This means that the value of the trust fund, including any growth, remains in the donor's IHT estate.

When a loan trust is set up, the donor or settlor makes a cash loan to the trustees which they invest in other assets, such as an investment bond. The donor or settlor does not make a gift and the loan, can be recalled at any time, remains within the IHT estate. Any growth in the value of the trust fund doesn't form part of the donor's IHT estate, as this is held for the trust beneficiaries.

Interest in possession (IIP)

Post March 2006, IIP trusts are subject to the relevant property regime for IHT purposes. This means there could be entry, 10-year principal and exit charges on distributions to beneficiaries (see discretionary trust section for further detail).

Discretionary trusts

Discretionary trusts are subject to the "relevant property" regime, which means gifts to these types of trusts are chargeable lifetime transfers and that IHT charges may arise in three circumstances:

1. On the setting up of the trust, known as an 'entry' charge.

Charged at 20% (or 25% if the settlor pays the charge) on the gift which exceeds the settlor's available nil rate band of £325,000, less any exemptions and reliefs;

2. A 'principal' charge of up to 6% every 10 years where the value of the trust fund is more than the prevailing nil rate band; and
3. An 'exit' charge of up to 6% may arise on payments of trust capital paid to a beneficiary in the first 10 years or after a principal charge has been calculated.

The value of a discretionary trust fund doesn't form part of any beneficiary's IHT estate because no beneficiary has an automatic right to the trust income or capital.

Setting up a discretionary loan trust will not constitute a chargeable lifetime transfer (CLT) for IHT purposes, so regardless of the value of the loan, no IHT entry charge will arise on the setting up of this trust. The discretionary loan trust will be subject to the relevant property regime, although the value of the outstanding loan will be deducted when calculating the principal charge.

What trusts might be considered?

1. Probate Trust

Can be written on a bare/absolute or discretionary basis. This type of trust is a settlor interested trust, meaning the taxation will be on the settlor/ donor as they have access to the funds during their lifetime.

This type of trust is good if there is no/ limited IHT liability as the money will count towards the estate, so has little IHT benefits. The main benefit is when the settlor or donor dies as the assets are owned by the trustees so do not form part of the estate for probate purposes.

If this is written on a discretionary basis, the relevant property regime applies, which could mean entry, 10-year principal and exit charges are a factor along with the trustees reporting these.

2. Gift Trust (bare or discretionary)

The gift trust is designed for IHT planning purposes.

The donor or settlor gift a lump sum to the trustees for the benefit of either named or a wide range of classes of beneficiaries.

The donor or settlor will not have access to any withdrawals or the capital of the trust fund so this needs to be affordable to them.

If the discretionary version is selected then the trustees need to understand the taxation and reporting requirements of the trust subject to the relevant property regime.

For the bare/absolute version, the beneficiaries and their shares from which they can benefit from the trust are known at outset and can't be changed.

The gift will be outside their estate after seven years and growth is outside from day one.

3. Loan Trust (bare or discretionary)

These trusts are suitable for clients who may be unable or unwilling to make outright gifts at this time but would like to start their estate planning journey and achieve some IHT savings on the investment growth.

They can be created on a discretionary or bare/ absolute basis, though if it's discretionary, the relevant property tax regime will apply and the trustees should understand the taxation and their reporting requirements.

The client retains access to the investment via repayment of loan. If the underlying asset is an investment bond, the 5% tax deferred allowance is usually used to repay the loan back to the donor or settlor.

While the growth accrues outside estate from day one, any outstanding loan remains inside the estate for IHT purposes.

The loan to the trustees is made usually interest free and the donor or settlor has the right to have the loan repaid to them on demand. Care should be taken with this though as there could be tax consequences depending on the underlying assets, how the repayment is made and the value of the repayment.

The donor or settlor could waive any outstanding loan making this a gift (PET or CLT) to the trust or to an individual. Please note that if this is a relevant property trust and the gift is over the nil rate band available then there could be entry charges to pay and this could in turn affect charges due on the 10th anniversary or when distributing to the beneficiaries.

The total repayments paid to the donor or settlor must never exceed the original loan and once repaid, no more payments can be received as they only have entitlement to the loan they made to the trustees and not any of the growth.

Early death may not achieve much IHT mitigation.

Provisions should be made as to how the outstanding loan should be dealt with on death. If there is no provision in the Will, it will usually have to be repaid to the estate.

Repaid - This could cause a chargeable event gain, which could be subject to income tax if a bond is the underlying assets of the trust. Who pays the tax will depend on the basis on which the trust was created and other factors such as the status of the settlor or trustees at the time of the chargeable event. This would reduce the benefit for the beneficiaries.

Alternatively, provisions could be added to the Will where the outstanding loan is waived or gifted:

Waived - The loan could be waived by gift to the trustees via the Will. The donor's or settlor's personal representatives can't waive the loan themselves, only act on instruction in the Will. Any outstanding loan would be inside the estate IHT but now the trustees have control of the underlying assets and if this is an investment bond, if any chargeable event occurs they don't need to repay the loan.

Gift to spouse/registered civil partner - this would be an exempt gift, giving more control over when a chargeable event occurs, if the underlying asset was an investment bond as the spouse has the same options as the settlor/donor when they were alive. Who pays the tax will depend on the basis of which the trust was created and other factors such as the status of the settlor or trustees at the time of the chargeable event. This loan could be further waived to trustees on second death.

Gift to other - Any outstanding loan would be inside the estate IHT. Gift would be a chargeable transfer and reduce the available nil rate band potentially. The recipient will have the same options for dealing with the loan as the surviving spouse/civil partner, with the same income tax consequences for the bond when a loan repayment is requested.

4. Discounted Gift Trust (bare or discretionary)

Main points applicable to both versions

This type of trust allows the donor or settlor to make an IHT effective gift to the trustees while retaining access to fixed withdrawals for life or until the fund is depleted. The requirement for these withdrawals is important as once the trust has been created and the retained benefits have been carved out then under our draft deeds, we can't alter the withdrawals or stop them. If the client does not need these withdrawals then a different trust might be more suitable as they could accumulate in their estate lessening the effectiveness of the IHT planning.

The gift into trust will provide an immediate IHT saving if a discount is agreed subject to underwriting, gift might be over the nil rate band.

The gift needs to be affordable to them as the donor or settlor will only have access to their retained benefits and not the rest of the trust fund. Growth will be outside the estate from day one, and the gift will be outside after seven years.

Can be written on a discretionary or absolute basis, making the gift a CLT or PET. If discretionary, relevant property regime applies and the trustees should understand the taxation and reporting requirements.

Can be written on a singular or joint settlor basis.

Benefits usually can't be distributed to the beneficiaries until the donor/ settlor's death.

The discount

Full underwriting should be completed prior to the trust being created to calculate the 'discount' on the amount gifted by the future market value of the regular payments which have been retained. This hypothetical price is what a buyer would pay considering:

- life expectancy and the level of the payments.

- the cost of life assurance to insure the life of the settlor/donor to protect the withdrawals if they died unexpectedly early.
- The tax due on these payments if they were above 5% tax deferred level. HMRC assume any gain will be taxed at 40% (with a 20% tax credit for onshore bonds).

This will then create two pots of money, the retained benefits payable to the donor or settlor and the gifted benefits for HMRC purposes.

Considerations:

When looking at the suitability of this type of trust the following factors may need to be considered:

- Withdrawals are fixed from the outset and any ongoing adviser fee taken from the investment bond will form part of the 5% tax deferred allowance. Care is required here especially if this is % based as this could cause a chargeable event which could lead to income tax charges.
- Trustees may need to make withdrawals to pay trustee expenses such as IHT charges on the 10th anniversary. The trust provisions should be checked to ensure this is permitted.
- If you were considering changing the underlying bond provider, this would be a surrender subject to the chargeable events regime and could have income tax consequences. Additionally the trustees have a duty to ensure the donor's settlors retained rights and withdrawals are met to the exact same amount, which can be difficult if reduced in value by a chargeable event gain.
- When the donor or settlor dies, their withdrawals will cease and will have no value for IHT. The remaining funds will be there for trustees to distribute/hold them until they want to distribute to the beneficiaries.
- Single or joint donors or settlors
 - Each person is underwritten separately, so if one person is unhealthy or there is a large age gap between joint donor's settlors then there could be a concern about the longevity of the fund lasting for the the survivor.
 - The tax status for joint settlors if discretionary version is chosen could play a part on your recommendation. For joint settlors when a chargeable event occurs, it would be deemed to be on a 50/50% basis, unless specified, which could mean additional tax to pay for them if they are alive and UK resident in the tax year when the chargeable event occurs. Also, if one of the settlors has previously died the chargeable event gain would be split between surviving settlor and trustees at 45%.
 - Single donor or settlor basis would mean that each surviving spouse could be beneficiary when they are a widow/widower once the donor or settlor has died, meaning no issues with pre-owned asset tax or gift of reservation of benefit and they could benefit from the trust fund not just the retained benefits.
 - It's important to keep a gifting record as depending on previous gifts given and the nil rate band available, joint gifts are deemed to be on a 50/50% unless documented otherwise.
- Settlor/settlor's spouse should not be life assured on the bond but there should be an ability to add younger lives assured to ensure policy continuity.

Flexible Gift Trust

These are interest in possession trusts (IIP) and those created post 22 March 2006, are subject to the relevant property regime so could have entry, 10 year principal and exit charges when distributing benefits.

There are two types of beneficiary for this trust, the life tenant, who has the rights to the property or to income produced from trust property and then there are the remaindermen, who have rights to capital after death of life tenant or if they give up their rights.

However, depending on the trust deed, the trustees may have the power to appoint future income to someone other than the income beneficiary in most cases and capital as well.

The trustees can mandate the income to be paid directly to the beneficiary rather than via trustees. This can reduce the administration for trustees and beneficiary.

If the trustees are looking to make distributions out to beneficiaries and they appoint to the spouse/civil partner, care and advice should be sought as the settlor may be able to benefit during their lifetime. This would be a gift of reservation of benefit and so taxed on settlor. This is especially true if the life tenant is the spouse/ civil partner.

The typical investments for this type of trust are assets which produce a real income such as fixed interest or dividends. Investment bonds may not be suitable as they are non-income producing assets and any withdrawals are return of capital, which the life tenant might not be entitled to.

HMRC Trust Registration Service

Most trusts, unless exempt, require to register with the Trust Registration Service. For more information about the TRS please see [Trust Registration Service Manual - HMRC internal manual - GOV.UK](#).

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