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# HOW TO USE TRUSTS TO REDUCE PROPERTY TAXES

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## About Jennifer Adams

Jennifer Adams TEP ATT (Fellow) FCG has been a professional business author for over 25 years, specialising in property tax. She is the proprietor of her own accountancy firm and owns a portfolio of properties. As such, she is well placed to advise on tax problems that landlords may face.

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## About this guide

This special guide tells you everything you need to know about trusts in relation to property under UK tax law. The guide looks at the different types of trust, how they are taxed, how each type can be used to manage assets over time and includes strategies on how trusts can be used to minimise taxes and secure the future of property assets.

# 1

## What is a trust?

Many believe that trusts are complicated to understand and expensive to run but, in reality, a trust is simply a private legal arrangement whereby assets are transferred to a group of people instructed to hold those assets for the benefit of specified beneficiaries (who may include the trustees themselves, but in a separate capacity).

Trust assets may be in any form including shares, cash or even the asset of most interest to *Property Tax Insider* readers — property, including a main residence.

### 1.1 Why set up a trust?

Trusts have been recognised in English law since at least the thirteenth century and are believed to have originated during the time of the Crusader knights as a way of protecting estate assets they owned when they were not around to protect them in person.

Protection was deemed necessary because when someone makes an outright gift to another, either during the donor's lifetime or on death in their will, the new owner assumes all rights over that property and may deal with it as they wish. In comparison, trusts offer a protective mechanism, allowing the person making the gift to impose certain conditions, thereby ensuring the property's security for the future.

The popular belief is that trusts are the exclusive preserve of the rich, who use them to avoid paying tax. However, as with the Crusader knights, the protection of assets and the transfer of wealth to future generations are still the main reasons for creating a trust.

By placing an asset within a trust, a settlor is giving up the legal ownership to a trustee who holds it for someone else or a group of people to enjoy the beneficial ownership. The settlor can declare themselves a trustee as well, but they generally cease to own the asset beneficially.

In summary, the reasons for creating a trust are:

- *Protection of an asset* – the beneficiary may become unable to manage the property themselves or become mentally incapable of doing so or be a minor (i.e., legally, a child under the age of 18 years in England and Wales, 16 years in Scotland) who cannot take on responsibility for the property themselves. Mental capacity is governed by the Mental Capacity Act 2005.
- Protection may also be desired should the settlor or beneficiary divorce or be made bankrupt (although this may not always be the case – see section 1.2).
- *Medium to long-term wealth management* – trusts are increasingly being used in determining someone's overall wealth strategy by either enabling specific assets to be included in the owner's estate or ensuring that the asset continues to be held for future generations and not sold.
- *Flexibility* – unlike an outright gift, a trust can be tailored to adapt to the changing circumstances of the beneficiaries. For instance, the owner

can provide for beneficiaries who may not have been born at the time of the trust's creation.

- *Trusts can also benefit those settlors who are married but wish to provide for children from a previous marriage.*
- *Provision of income* – a trust can enable an income from assets to be given to one person (e.g., a surviving spouse or civil partner) whilst keeping those assets safe for future generations – this is particularly relevant to rental properties.
- *Reduction of tax* – property placed within a discretionary trust may fall outside the settlor's estate for inheritance tax purposes, subject to conditions (including surviving for seven years and anti-avoidance rules – see section 1.2).
- *Entitlement to state benefits* – once assets are placed within a discretionary trust, they no longer belong to the donor or the beneficiary. As such, capital held within the trust may not be treated as the beneficiary's capital for means-tested benefits. However, this depends on the structure of the trust and anti-avoidance rules such as deprivation of assets. (see Trap below).
- *Different jurisdictions* – trusts can be designed to assist with generational transfers of assets based in different jurisdictions, helping to avoid complexity, cost and delays following death.

#### Trap

A trust may be considered as a way to ensure a property is not taken into account when determining future care home costs, but be aware – the local council may consider this action to be 'deprivation of assets', i.e., the intentional reduction in assets so as not to be included in the council's calculation of contribution towards care costs. Specialist advice should be sought, should this be the intention.

## 1.2 Proviso – An added layer of protection

As stated in the previous section, one of the main reasons for creating a trust is that it adds a layer of protection between the settlor and anyone who may lay claim to their estate, be that regarding bankruptcy, divorce or any post-death claims. However, this may not always be the case, as shown in the following examples:

- *Bankruptcy* – the mere existence of a trust does not, in itself, offer protection. There will be none if, when making the transfer into the trust, the settlor is already insolvent (or becomes insolvent due to the transfer) or if the transfer is made to avoid creditors. Timing is important and the courts will examine all evidence to ascertain the real reason for the creation of the trust. Generally, if a trust was created more than five years before insolvency, that will be acceptable. Transactions created within five years are particularly vulnerable to challenge, although there is no strict time limit where intent to defraud is established.
- *Divorce* – the divorce courts have wide-ranging powers for distributing assets between divorcing spouses (or civil partners) and for making provision for any children. The court has the power to vary trusts for the benefit of a party or to extinguish or reduce the interest of either of the parties.