



TRUSTS EXPLAINED

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ADVISING FAMILIES ACROSS GENERATIONS

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Many people, often without realising it, will come into contact at some point in their lives with a trust in one form or another. Yet trusts are widely misunderstood and often seen as something just the wealthy 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 about a specific jurisdiction you should contact a local TEP¹ advisor.

¹ TEP (Trust & Estate Practitioner) is the designation given to full STEP members. All are qualified experts in trusts and other aspects of estate and inheritance planning.



WHAT IS A TRUST?

In principle, a trust is a very simple concept. A trust is the formal transfer of assets (it could be property, shares or just cash) to a small group of people (usually two or three) or to a trust company with instructions that they hold the assets for the benefit of others.

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 those who benefit from the trust are called 'beneficiaries'. 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 interests of the beneficiaries above their own. Thus, the settlor of a 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 or shortly after the death of the settlor. 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 and play a key role in many aspects of everyday life. In the UK, for example, most company pension schemes are structured as trusts, and in Australia, a super fund is a special type of trust, set up and maintained for the sole purpose of providing retirement benefits to its members (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 ensures that the deceased's wishes about how the insurance funds are to be distributed can be followed quickly and accurately.

Trusts (as well as foundations) are also very commonly used for charitable funding. 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 research projects should be funded. The settlor can leave a letter of wishes for the trustees expressing their wishes in further detail, if desired, or most decisions can be left at the trustees' discretion. 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, discretionary 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; this can be particularly important for families where there are children from previous marriages.
- to protect the inheritance of young children until they are old enough to take responsibility for their own affairs;
- to provide for vulnerable relatives who are unlikely to be able to look after their own affairs;
- to help succession planning in a family business.

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, makes trusts an excellent tool for making long-term plans to ensure a family's financial security.



ARE TRUSTS SECRET?

Trusts are personal 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 confidential.

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.

The general public thus usually has limited or no access to information on family trusts. Trusts, however, are far from secret. In many jurisdictions, trusts are subject to tax and must file tax returns with the tax authorities, providing details of both the trust's finances and information on those associated with the trust. Trusts, like most other forms of savings, are also fully subject to extensive international agreements to automatically share information between tax authorities.

It is not just tax authorities who have access to information on trusts. Trusts, again like most other forms of savings, are also subject to extensive international money laundering regulations. The trustees must therefore keep records of all those associated with the trust and make information available to official investigators if needed.

These requirements are designed to preserve legitimate confidentiality for family trusts, but at the same time make trusts transparent enough to act as a significant deterrent for anyone trying to use a trust either to evade taxes or hide the proceeds of crime or corruption.

TRUSTS AND TAX

Trusts are occasionally represented 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 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. 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 US, for example the declared intent of the Internal Revenue Service is that there should be no income tax advantage to trusts and there are onerous trust reporting requirements. Similarly, in the UK, 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. 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.



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 jurisdiction 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 in recent 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 often 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 Organisation for Economic Cooperation and Development 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

Trusts are a way for families to securely hold assets and pass them from one generation to another. As such, as with most other forms of savings, they are subject to the global economic uncertainties and volatile capital markets that have marked the past ten to 15 years. Three broad trends nevertheless stand out that point to on-going demand for trusts as a means of helping families pass assets from one generation to another.

First, in spite of the economic volatility of recent years, families generally continue to benefit from rising prosperity. With rising prosperity comes a natural concern to ensure that future generations also benefit from greater financial security. Trusts can play an important role here.

Second, families generally are becoming more complex. Not only are families more often seeing parents and children who divorce and re-marry, families are also becoming more complex geographically. Trusts, again, can have a key role in helping families negotiate the complexities this can create for inheritance planning.

Third, family members are living longer. Increasingly, therefore, families need to ensure long-term support for older family members while also securing the future of younger family members. The flexibility of trusts can be of considerable benefit in these circumstances.

Professional advisors therefore generally remain confident that trusts will continue to provide practical solutions to problems in ordinary people's lives.

A young child with curly hair is resting their head on a plaid shirt. The child is looking towards the camera with a slight smile. The background is softly blurred, showing what appears to be another person's hair and shoulder.

WHAT IS STEP?

STEP is the worldwide professional association for those advising families across generations. We help people understand the issues families face in this area and promote best practice, professional integrity and education to our members.

Today we have 20,000 members across 95 countries from a range of professions, including lawyers, accountants and other specialists. What connects our members is that they all help families plan for their futures: from drafting a will or advising family businesses, to helping international families and protecting vulnerable family members.



This leaflet as well as other informational leaflets are available to view and order at www.step.org/leaflets

For more information about STEP please visit our website www.step.org

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