2024/25

# HOW TO USE TRUSTS TO REDUCE PROPERTY TAXES

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# Contents

‘How To Use Trusts To Reduce Property Taxes’ – First published April 2012; revised April 2013, April 2014, April 2015, April 2016, May 2017, April 2018, April 2019, April 2020, April 2021, April 2022, April 2023 and April 2024

# About Jennifer Adams

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She is the author of the following Tax Insider guides:

- Tax Tips for Company Directors
- Investing In Property – Personal Or Company Ownership
- Dividend Tax Savings Strategies Explained
- How to Maximise Landlord Expenses

# About this guide

This special guide tells you everything you need to know about trusts in relation to property with reference to the UK's tax laws 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 others or themselves.

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 assumed to have come into being at the time of the Crusader knights as a way of protecting the estate assets they owned when they were not around to protect them in person.

Protection was felt 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 to deal with as they wish. In comparison, creating a trust enables the person making the gift (the 'settlor') to attach certain conditions.

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 passing of wealth to future generations are still the main reasons for creating a trust, although there are other reasons.

In summary, the reasons 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 possible 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* – a trust can be created to adapt to the beneficiaries' changing circumstances, whereas an outright gift cannot, e.g., the owner may wish to provide for beneficiaries who may not have been born at the time of the creation of the trust. 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 the 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 let property.

*Reduction of tax* – property placed within a discretionary trust does not form part of the settlor's estate on death and, as such, reduces any inheritance tax liability that otherwise might be charged (however, see section 1.2 below).

*Entitlement to state benefits* – once assets are placed within a discretionary trust, they no longer belong to the donor or the beneficiary. As such, the capital held within the trust is not considered when assessing entitlement to state benefits (e.g., Universal Credit).

*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 of ensuring that 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 care costs contribution. 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, it needs to be pointed out that this is not always the case:

- *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. However, there is no time limit if the intention was to defraud creditors.
- *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.

- *Post-death claims* – where the court is satisfied that within six years before death, the deceased made a disposition into a trust with the intention of defeating a claim under the Inheritance (Provision for Family and Dependants) Act 1975, it may order the trustees to pay some sum to the claimant as financial provision.

## 1.3 How a trust is created

There are no strict legal formalities required to create a trust (except concerning land) but it is common for a settlor (i.e., the person creating the trust – see section 1.4) to create a trust instrument (normally referred to as a trust deed – see below) in which is set out the obligations of the trustees (see below). There are three 'certainties' that must be present for a trust to be created, namely, certainty of intention on the part of the settlor to create a trust; certainty as to the subject matter of the trust (i.e., the property to be settled) and certainty of objects (i.e., the beneficiaries of the trust).

The trust deed may set out the following:

- who the trustees are to be;
- how new trustees are to be appointed should the situation arise (e.g., because a trustee dies or no longer wishes to continue);
- the removal, retirement and replacement of trustees;
- the duties of the trustees;
- the powers of the trustees, including any powers they may have to appoint new beneficiaries, and what discretion they have in investing, making payments, and the buying and selling of property;
- how trustees' fees and expenses are to be met;
- detail as to what happens to funds held within the trust after the prime beneficiary dies; *and*
- any specific requirements for the use of the assets and income.

### Practical points

- Whatever the type of asset involved, it is always advisable to have a formal written trust deed as this helps to avoid any future misunderstandings.
- Legally, the trustee must comply with the terms of the trust deed. However, the settlor can provide a letter of wishes as a guide to the trustees explaining how they would like to see the trust fund operate, setting out the settlor's wishes and intentions in establishing the trust. Note: a letter of wishes is not a legally binding document.

## 1.4 The principal roles

**The settlor**

All trusts have a settlor. The settlor is the person who transfers the legal ownership of the assets to the trustees. Anyone can be a settlor with no restriction apart from the fact that they must own the property intending to be transferred into trust.