Introduction to Trusts

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[Slide: Overview]

1. Welcome to STEP – a few words about C-BEG

[Slide: 1. STEP and C-BEG]

First of all, welcome to STEP – the Society for Trust and Estate Practitioners. I am glad to welcome our newest branch, STEP Hungary. Despite the name, STEP members deal with all aspects of family succession planning, not just trusts. I am delighted by the continuing expansion into civil law and other non-English jurisdictions where trusts have been traditionally unknown. STEP provides an excellent opportunity both for common law practitioners to connect with and educate civil law practitioners about our succession laws and taxation, but equally for civil law practitioners to connect with and educate us about their own systems.

I am a member of the STEP Cross-Border Estates Group steering committee. Although our group title emphasises estates rather than lifetime trusts, all of us work regularly with both, as well as with succession techniques and related issues under the laws of many non-common law jurisdictions, where we work frequently with local experts. I am a member of the bar of both England and Wales and of New York, so my own cross-border practice tends to deal with the border between the UK and the US, but it also encompasses the interaction between the UK and elsewhere or the US and elsewhere. As families and assets are increasingly dispersed across national and other borders, it is quite common for cross-border issues to arise involving more than two jurisdictions.

I would also like to acknowledge the founder of C-BEG, Richard Frimston, whose contribution to the on-line STEP Wiki (http://www.stepnetwork.net/) I have drawn on heavily in preparing this talk.

[Slide: 2. What is a Trust?]

2. What is a Trust?

First of all, there is not one single law of trusts. Although originally stemming from the common law courts of England, the law of trusts has had a more or less independent existence across many jurisdictions – many of them former British colonies – and there are many variations, both minor and major. There are even considerable differences between the present trust laws of England and Scotland. In addition to that, there are separate trust statutes and cases in Ireland, each of the United States, former British colonies in the Caribbean, Canada, Australia, Hong Kong, Singapore, the Channel Islands, etc. Also, each of these jurisdictions has a different approach to the taxation of trusts. I am not going to attempt to describe for you all the details of any one trust jurisdiction, but rather to give you a general picture of the central concepts.

The traditional purpose of a trust is to provide for family, continuing ownership and management of assets and succession, and this is my focus today. Trusts are also used for commercial and business purposes such as pension funds, investment funds, sometimes for the carrying on of a business but more commonly for organising and coordinating control of a group of businesses.

In civil law systems, these purposes are usually served by a variety of structures which may have either business or personal uses – companies, partnerships, and the various forms of foundation – anstalt, stiftung, etc. It is tempting to assume that a trust is simply the same as the corresponding civil law entity, but there are important differences.

English law and Continental law have followed independent courses throughout their histories – just as the original English law has followed somewhat independent courses among the various jurisdictions that have inherited it. Among these jurisdictions, the law of trusts is broadly the same, though variations have occurred over the centuries between independent jurisdictions.

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 land, shares or cash) is transferred to one or more "trustees" to look after and use those assets for the benefit of a one or more "beneficiaries."

[Slide: Typical Trust]

In this example, there is a Settlor who initially owns some assets. In the UK and most former British colonies apart from the United States, the person giving the assets is usually known as the "settlor". This term may also be used in the US, but other similar terms may also be seen such as "grantor," "creator," "trustor," etc. These all mean the same thing.

The Settlor has transferred assets – shares, cash and a house – in trust, to a Trustee, who must then look after the assets. There may be one or more Trustees, and they may be individuals or companies. There is generally no requirement that an individual be a lawyer or other professional, though this is often the case. An individual Trustee is also typically a family member or close friend of the Settlor or Beneficiaries. In some jurisdictions, a company may only act as a Trustee if it is one of certain regulated financial institutions, but this is not generally the case.

The Trustee owns the assets, has the sole power to buy, sell and manage them, but he has a fiduciary duty to do so only in the best interests of the Beneficiaries. He may not personally profit from his actions as Trustee. If he fails in this duty, he may be personally liable to make restitution to the trust fund.

The Trustee collects the income, out of which he may pay proper expenses, such as upkeep and insurance on the house, and then pays the net income to the Beneficiary – whom the Trustee also allows to reside in the house, in accordance with the terms of the trust.

The details of the arrangement are usually laid out in a written document, which may be a last will and testament, or a "trust deed," “trust agreement,” etc., and the assets placed in the trust are the "trust fund". (In English law, there are also situations where a trust or trust-like relationship arises without an express agreement – an “implied,” “constructive” or “resulting” trust, for example where assets have been misappropriated – but in this talk I am describing only “express” trusts, intentionally created by a Settlor by an express written document.)

Trusts can take effect during the lifetime of the Settlor (in which case they are called a “lifetime settlement” or “*inter vivos* trust”) or only upon the death of the Settlor (in which case they are called a “will trust” or “testamentary 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.

It is important (particularly for those accustomed to civil law systems) to understand that a trust is not a legal person, as a company is. A trust does not own assets, enter into contracts or act by itself, as a company does. It is the Trustees who legally own the assets and who may contract and act within the terms of the trust.

It is best to think of a trust not as a legal entity but as a relationship (among the Settlor, Trustee and Beneficiaries) whereby legal ownership and beneficial ownership are separated. This fundamental feature of the trust has historically caused difficulties in civil law systems, both in understanding what a trust is and how it works, but also – importantly – in deciding how to tax it. (Discussed later.)

In fact, though, if you only look at the slide, it is not obvious how a trust differs from, say, a company – assets are held in a structure, managed by one party who pays the income to another, much like a company paying dividends. The important differences are in the duties of the Trustee and in the nature of the Beneficiary’s interest.

[Slide: Traditional Features of a Trust]

These are some of the traditional features of a trust. Some of these features have been modified by statute in various trust jurisdictions, and some may be modified by the terms of the trust document (but some may not).

- The Trustee is the legal owner of trust assets

    This remains true in all trust jurisdictions. A consequence is that a Trustee is personally liable when he, for example, enters into a contract unless he signs with the words “as trustee” after his signature. In modern practice, and particularly in a commercial context, it is usual to limit the Trustee’s liability or to indemnify him from the trust assets. While, for tax purposes in the legal systems based on English law, trusts are often treated as a separate, taxable entity – it is important to remember that it is the Trustees who legally own assets and act "on behalf" as it were of the trust, though it is more accurate to say that they act within its terms.

- The Trustee has fiduciary duty to act only in the interest of the Beneficiaries

  The Trustees must at all times put the interest of the Beneficiaries above their own. Even if the Settlor of a trust is also a Trustee, he must still act in the interests of the Beneficiaries, not himself. He must also balance the sometimes opposing interests of income Beneficiaries and those who will receive the capital. Most trust jurisdictions have a set of rules governing the Trustee's duties – acts he must or must not do, types of investments he may make, limits on the extent to which he may personally profit. These may be modified by statute or drafting to allow Trustee to be compensated, or engage in self-dealing, etc., but in some cases the fundamental rules may not be altered.

- The Trustee may only invest in specified types of conservative assets

  This traditional rule has been relaxed in most jurisdictions, but the Trustee still liable if he invests carelessly.

- The Trustee may have wide discretion to decide amounts distributed

  He may also be given very specific and narrow instructions

- There are usually Successive or overlapping beneficial interests (e.g., life interests v. remainders)

  (To be discussed a bit later.)

- There may be Restrictions on the Beneficiary's right to alienate his interest

  This varies by jurisdiction, but a number provide that certain interests cannot by alienated unless the trust document specifically allows – this may mean that the assets or income may not be reached by the Beneficiary's creditors.

- Trusts have a Limited duration – the Rule Against Perpetuities

  This rule was originally seen as necessary to prevent the difficulties that would arise if legal ownership could be tied up with trust restrictions indefinitely. This was a problem particularly for trusts of land, where it was feared that Trustees might never be able to give free title.

[Slide: Rule Against Perpetuities]

The traditional Rule Against Perpetuities is simple to state as "An interest must vest or fail to vest within lives in being at the time it is created plus 21 years." This simple sentence, however, is notoriously difficult to apply, and has been the bane of many a law student's existence. It is fairly easy to get it wrong, and the consequence of doing so was traditionally that the purported interest was invalid.

Because of the difficulty and harshness of the traditional rule, is has been modified or abolished in many jurisdictions. Some have adopted a maximum duration of a fixed number of years (typically 80, 90, 100 or 150 years), while a growing number of other jurisdictions have abolished any time limit in order to attract Settlors and Trustees looking to establish perpetual trusts.

The situation is now much more straightforward in many jurisdictions, but note that there can be technical problems arising from the differences among jurisdictions when trying to relocate a trust or change its governing law.

Note also that charitable trusts have generally not been subject to the rule.

[Slide: 3. Why Use a Trust?]

3. Why Use a Trust?

In the systems based on English law, Trusts are very common indeed and play a key role in many aspects of everyday life.

[Slide: Pension Trust]

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.

[Slide: Charitable trust]

Many charities are organised as trusts. 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 the ability to specify how assets will be used in the future (even after the Settlor's death) while also allowing the Trustees to respond to situations the Settlor may not have foreseen.

[Slide: Discretionary Trust for Family]

In the simplest and most flexible example, the Trustee is instructed to benefit any or all of the Settlor's widow and children – and the Trustee has discretion in deciding how much to pay each of them (and may pay them different amounts according to need, or pay all to one of them, etc.)

Often, though, the Settlor will want to give more specific instructions to the Trustee to meet his family's circumstances. 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

[Slide: Life interest Trust for spouse]

In this example, instead of simply giving assets to his spouse, who may remarry and start a new family, the Settlor gives his spouse the right to all the income from the Trust Fund but guarantees that the capital will eventually pass to his own children. Or perhaps this was already a second marriage, and the Settlor has children by a previous marriage whom the present spouse might not look after. Another use is …

- to protect the inheritance of young children until they are old enough to take responsibility for their own efforts

[Slide: More Specific Provisions [1]]

Here, the children are not entitled to all of the income or capital until they have reached a suitable age – 21, 35, 50 or whatever. Or it may be desirable (for tax or other reasons) not to let the children ever have the capital but to keep it in trust for the grandchildren. Another use is …

- to provide for vulnerable relatives who are unlikely to be able to look after their own affairs

[Slide: More Specific Provisions [2]]

Perhaps there is an issue with only one of the children – here, the other children may receive their shares on the spouse's death, but the share of vulnerable Child X stays in trust. Other uses are …

- to help succession planning in family businesses (where keeping ownership and control within the family across generations may be desirable), and

- to segregate assets to take advantage of tax allowances, etc.

[Slide: Additional Discretion]

It is also possible, while giving specific directions to the Trustee to allow those instructions to be deviated from in appropriate circumstances. These could include changes in tax laws or a change in the Beneficiaries' circumstances – change of residence, differing financial needs, etc. The Settlor's spouse could have ample means of her own, for example, and so it may be appropriate to give more funds to the children instead, or one child may be very successful while another develops a greater need for money – perhaps for medical reasons. Or one child may be subject to claims of a creditor as a result of business activities or in the context of a divorce, in which case it is often advisable to convert a life interest or automatic entitlement to capital into a mere discretionary interest.

This sort of flexibility can be provided by giving the Trustee an "overriding power of appointment" which allows the Trustee to appoint funds away from one Beneficiary to another, or convert a life interest into a discretionary trust, for example. It is also common to give a Beneficiary the power to adjust the shares passing by default equally to his children.

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.

[Slide: 4. Are Trusts Secret?]

4. Are Trusts Secret?

Trusts, like bank accounts and most other family financial affairs, are 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 are the Settlor, Trustees or Beneficiaries or how much the fund is worth. Note, though, that in some jurisdictions, a will is a matter of public record, and so the terms and initial funding of a trust established by a will can be made public, though there are ways to limit this. It is also true that 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 often 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 his 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 Cooperation 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).

[Slide: 5. Trusts and Tax]

5. Trusts and Tax

Trusts are sometimes misrepresented by commentators as just devices to avoid tax, and they are widely perceived by the public and a disturbing number of politicians as vehicles to hide funds from tax authorities. In fact, this is no more true of trusts than it is of companies or bank accounts. There are increasing obligations to disclose the existence of trusts in supposedly secretive offshore jurisdictions, just as with companies and bank accounts, and there are severe penalties and tax consequences for those who fail to comply. A British or American Settlor or Beneficiary will generally be taxed at least as much with respect to an "offshore" trust as if there were a domestic trust or no trust at all, and indeed there may be penalties and additional tax burdens that outweigh any possible tax advantage.

That said, there are situations where using a proper trust may reduce a tax burden by managing tax allowances and consequences efficiently.

In many cases, 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 Internal Revenue Service is that there should be no income tax advantage to trusts and there are onerous reporting requirements for "foreign" (i.e., non-US) trusts. Within a purely domestic US context, however, trusts are widely used with no controversy and no adverse tax consequences. In fact, in at least one US context – the estate taxation of a deceased individual who was married to a non-US citizen – a trust is <u>required</u> to achieve a tax advantage otherwise generally available to all married persons even without a trust.

[Slide: Discretionary Trust for Family]

If we look at this slide again, we may ask: "How is this trust taxed?" There is no one answer. First, each jurisdiction will have its own approach, but even within each jurisdiction it will depend on various factors. The UK and US, for example, will generally want to impose an inheritance or gift tax on the initial transfer by the Settlor to the Trustee. This transfer may, however, simply use up an exemption from those taxes, or it may be exempt as a marital gift during the lifetime of the Settlor's spouse. (Not if it is a discretionary trust like this one, but a life interest trust for the spouse might qualify for tax deferral in the US, for example.) If that is the case, the trust assets will usually be subject to inheritance, gift or estate tax on the death of the spouse.

[Slide: Typical UK Will Trusts]

In this example of a very common estate plan in the UK, for instance, we see that the estate of the deceased Settlor is divided into the amount that is exempt from inheritance tax on his death by virtue of the "nil rate band" – which currently exempts the first £325,000 – and the balance of the estate. The nil rate band amount may remain in trust for the benefit of the Settlor's widow and children and will in essence remain exempt from UK inheritance tax as long as the trust lasts. The balance of the estate is held in a life interest trust during the widow's lifetime, paying her all the income. This amount is not taxed at the Settlor's death, but on the widow's death it will be subject to inheritance tax at 40% (subject to whatever remaining allowances the widow may have). In the illustration, the widow's life interest trust remains in trust for the children and grandchildren after her death. It used to be the case that this amount might not be subject to further inheritance tax until each child dies (as is generally still the case in the US), but the UK tax rules were changed several years ago to provide that in this particular scenario, the trusts following on after the widow's death are now subject to a 6% tax every ten years – the idea is to try to ensure that the funds are taxed at approximately 40% at every generation.

With respect to income and capital gains within the trust fund, the UK and US will often seek to treat the income and gains as belonging to the Settlor while he is alive and taxed along with his other income and gains. This is to prevent a wealthy Settlor from artificially reducing his income, which may be taxed at the highest rate, by shifting it to Trustees or Beneficiaries who would be taxed at a lower rate. If the Settlor is no longer living (or if the Settlor has not retained any deemed interest or control), then the UK and US will generally seek to impose income and capital gains taxes on the Trustee (to be paid out of the Trust Fund) to the extent those the income and gains are retained within the Trust Fund, but if they are distributed to the Beneficiaries, then the UK and UK will generally seek to include them with the Beneficiaries' other income and gains and tax them accordingly. The general principle is to try to tax the income and gains during the Settlor's life just as if there were no trust, and thereafter to ensure that they are taxed roughly the same whether retained by the Trustees or paid out to the Beneficiaries – thus it is tax neutral.

In any event, there are detailed rules for determining who is taxed with respect to what capital or income at each stage, and these are designed to ensure that no one is taxed more or less than if there were no trust.

Difficulties may arise, though, where more than one jurisdiction is involved and they impose tax on different persons or events. This is often a risk where the US and UK are both involved, since even though their trust laws are broadly similar, their tax rules are quite different. It is even more likely to be a problem, however, where a jurisdiction that does not recognise trusts is involved. France, for example, might look at this structure …

[**Slide: Discretionary Trust for Family]**

… and conclude that the Trustee is the legal owner, and so try to tax the Trustee (personally) on trust income while the UK, for example, would tax the Settlor, so tax is collected twice. France might also look at distributions made by the Trustee to the Beneficiaries and treat them as gifts made by the Trustee (who is perhaps unrelated to the Beneficiaries) and impose a higher tax than they might on a gift from the Settlor to his own wife or children. This sort of mismatch for tax purposes can cause potentially costly complications in the international context that is increasingly common, as family members disperse across jurisdictions. There is some encouragement to be found, however, in the spread of tax treaties and other efforts toward the international recognition of trusts.

6. International Trends in Trusts

[Slide: 6. International Trends in Trusts]

Families are 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 preeminent 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.

Obviously, the trust is a common law concept. The typical continental lawyer may not recognise a trust and will believe that his law does not recognise trusts. The Hague Trusts Convention XXX of 1st July 1985 is now in force in Australia, Canada (other than Ontario & Quebec), Italy, Liechtenstein, Luxembourg, Malta, Monaco, the Netherlands, San Marino, Switzerland and the United Kingdom. It has also been signed or otherwise agreed to, though not yet in force, by China, Cyprus, France and the United States.

The Convention is designed to clarify issues of jurisdiction and choice of law and to provide for multilateral recognition that trust assets do not generally form part of the Trustee's personal assets. It does not resolve all potential issues, particularly to do with tax, but it is a great step forward.

As a result of the Convention, it would seem that Italy may now be beginning to develop the concept of an internal trust in Italy, while the Netherlands is not. We will see how Swiss law develops, but the concept of an internal Swiss trust is less likely. We are all eager to see how the newly-enacted Hungarian trust law will develop.

7. The Future

[Slide: 7. 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.

The major threats to trust growth 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 often not 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. In general, as trusts are popularly perceived (incorrectly and unfairly) as only vehicles for the super-rich to dodge tax, it is unlikely that politicians will make addressing some of the unfortunate tax complications – particularly in the international context – a priority in the foreseeable future. There has been a long-term trend, though, of increasing international cooperation, and slowly but surely, it is to be hoped that progress may be made when political convenience allows.

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.

[Slide: Last page]

Thank you very much. I would be happy to take a few questions if there is time.