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Overview of Trusts: Key Tax and Legal Issues

Introduction

The purpose of this article is to provide a general overview of the concept of a trust and the uses of a trust. It will examine the main features of the various types of trusts and when they are generally used and will focus in particular on the use of discretionary trusts to provide for different types of beneficiaries, with an overview of the tax implications. In addition, it will briefly address recent developments in the move towards greater transparency and disclosure of beneficial ownership information in Ireland in relation to trusts.

What Is a Trust?

There have been many attempts to define what a trust is. Essentially, it is an equitable obligation binding on persons, called trustees, who are required under the terms of the trust to hold and deal with property separate and distinct from their own property, for the benefit of a person or class of persons known as the beneficiaries.

In very simple terms, the person who creates a trust, the settlor, essentially gives property to the trustees and requests them to hold that property for the benefit of certain beneficiaries. The different types of trusts arise from the different types of instructions that are given to the trustees in the trust instrument regarding how they hold the property they are given. A common misconception is that the assets in the trust fund are legally owned by the trust itself. However, a trust, unlike a company, cannot own assets. The trustees are the legal owners of the assets. One of the distinctive features of a trust is 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.

Trusts are very common and play a key role in many aspects of everyday life. For example, certain pension schemes are structured as trusts. Similarly, many life insurance policies are "written in trust". Trusts are also very commonly used for charitable purposes, with a number of charities established as trusts. They can also be used for wealth protection and succession planning, generally and specifically in relation to family businesses or dealing with complex family dynamics such as where the settlor has children from both an existing and a previous marriage.

Trusts can take effect during the lifetime of the settlor, or can be created by will upon the death of the settlor.

For legal purposes, there are a number of different types of trusts. However, for tax purposes there are essentially three basic types: bare trusts, discretionary trusts and fixed trusts.

Bare Trusts

A bare trust arises where property is vested in the trustees as nominees. The trustees hold the property on trust for a person beneficially entitled absolutely to the assets. Generally, the trustee will have no active duties to perform and is simply holding legal title to the property. The beneficial owner can call on the trustees to transfer the property to him or her at any time. A bare trust is commonly used where assets are held on behalf of minor children, who, because of their minority, may not hold an interest in trust property directly.

A bare trust can be in writing or implied or could arise where a contract is signed "in trust".

Tax implications

A bare trust is generally transparent for tax purposes. The assets in the trust are regarded as belonging to the beneficial owner during the term of the bare trust.

Capital acquisitions tax (CAT), capital gains tax (CGT) or stamp duty may arise on the creation of the bare trust, depending on the nature of the assets that are being placed in the trust. The beneficial owner is liable at the date the trust is created for any CAT liability that may arise. A CGT liability may arise for the settlor of the trust. Any stamp duty liability may be assessed on the beneficial owner at the date of settlement (unless it is a transfer at undervalue – for example, a gift – in which case both the settlor and the beneficiary would be accountable).

Subject to certain exceptions, if a gain arises or income is earned during the trust period, it is chargeable on the beneficial owner.

No liability to tax arises from a CAT, CGT or stamp duty perspective when the bare trust comes to an end and the trustee transfers the property to the beneficial owner when called upon by the beneficial owner to do so.

Discretionary Trust

A discretionary trust, for legal purposes[1], is essentially a trust in which the settlor transfers property to the trustees and gives the trustees absolute discretion as to which beneficiary or beneficiaries from a class of beneficiaries specified in the trust deed is to benefit from the property held on trust. The trustees have

1 For tax purposes the definition is broader, as outlined below.

absolute discretion regarding the amount of the benefit that the beneficiaries should receive and when they should receive it. The beneficiaries have no interest in the trust fund for legal or taxation purposes and have no right to either income or capital from the trust until such time as the trustees exercise their discretion to make an appointment from the trust. Given the wide discretion that trustees are given when a discretionary trust is established, it is usual for a discretionary trust to be accompanied by a letter of wishes to the trustees providing them with guidelines on how the settlor or testator (if the trust is created by will) would like the trust fund to be distributed. Unless there are particular reasons not to do so, the trustees will usually take these wishes into account, albeit that they are not legally binding on them.

Discretionary trusts are very popular vehicles that are routinely used by private clients in structuring their assets either during their lifetime or on death. However, before establishing a discretionary trust, it is important to consider the implications of the structure under the various tax heads.

Tax implications

Discretionary trust tax

The definition of a discretionary trust for tax purposes is broader than what would generally be considered to be a discretionary trust for legal purposes. The definition for tax purposes includes certain maintenance and accumulation trusts,[2] in addition to "any entity which is similar in effect to a discretionary trust…irrespective of where it is described in the place in which it is established".[3] This is very broadly drafted; however, according to Revenue's CAT Tax and Duty Manual - Part 5 Discretionary Trust Tax, the definition is essentially designed to ensure that entities such as foundations should, irrespective of their location, fall within the charge to discretionary trust tax (assuming that they fall within the territoriality rules).

Whether a trust falls within the charge to discretionary trust tax is based on the domicile of the disponer (for trusts established before 1 December 1999) or the residence or ordinary residence of the disponer (for trusts established on/after 1 December 1999). Otherwise, only trust assets that are situated in Ireland are chargeable to discretionary trust tax.

Discretionary trust tax imposes an initial levy of 6% on the market value of the trust fund. However, the legislation provides for a refund of 50% of the initial levy if the trust is wound up and all of the trust assets are appointed absolutely to beneficiaries within five years.

The initial levy arises on property that is subject to a discretionary trust on the later of:

- the date on which the property becomes subject to the discretionary trust;
- the date of death of the disponer; or
- the date on which there ceases to be a principal object under 21 years of age (where property is settled on/after 31 January 1993).[4]

A principal object is defined to include a spouse or civil partner of the settlor, the children of the settlor or of his or her civil partner/spouse or any children of a predeceased child of the settlor or of his or her civil partner/spouse.

In addition to the initial levy, an annual levy is charged on the value of the assets comprised in a chargeable discretionary trust on 31 December in each year. The 1% annual levy will not arise in the same 12-month period as the initial levy.

Section 111(1)(b) of Finance Act 2012 introduced an amendment to s15 CATCA 2003 which

2 Section 2(1) of the Capital Acquisitions Tax Consolidation Act 2003 (CATCA 2003).

3 Section 2(1A) of CATCA 2003.

4 Section 15 of CATCA 2003.

provides that property will be treated as being subject to a discretionary trust on the date of the disponer's death where the discretionary trust is created by his or her will.

This essentially means that where a discretionary trust is created under a will, the initial charge to discretionary trust tax will arise on the date of death of the disponer and the annual charges will arise on 31 December in each subsequent year during the period of the administration (assuming that all principal objects (if any) are over 21 and no interest in possession arises). The charges, however, will not become payable until four months after the valuation date arises.

CAT

Generally a beneficiary of a discretionary trust is not liable to CAT when the trust is settled, as at this date no beneficiary is beneficially entitled in possession to any benefit.

A charge to CAT will arise when the trustees exercise their discretion and the beneficiaries receive an appointment from the trust if:

- the settlor is Irish resident/ordinarily resident at the date of establishment of the trust or at the date of the benefit;
- the settlor was, in the case of a gift taken after his or her death, Irish resident/ordinarily resident at the date of death;
- the beneficiary is Irish resident/ordinarily resident at the date of the gift; or
- the asset being gifted is Irish-situate property.

These rules apply to trusts established on or after 1 December 1999.

CGT

CGT may arise on the disposal by the settlor of chargeable assets to a discretionary settlement created during the settlor's lifetime. A discretionary trust created under a will of a deceased person will not attract CGT when assets are settled on a death.

The appointment of an asset from a trust is a taxable event for CGT purposes, albeit that usually there is a credit available for any CAT paid. This credit would be lost if the beneficiary sold the chargeable assets received by him or her within two years.[5] The trustees are assessed for CGT purposes on the gains made by the trust during the period in which the assets remain under the discretionary trust.

In addition to incurring a liability to Irish CGT on actual disposals that the trustees make during the trust period, they are also deemed to dispose of assets in certain circumstances, to include:

- a person becomes absolutely entitled to the assets as against the trustees;
- on the death of a life tenant if the property remains settled; and
- on the migration of a trust abroad, in accordance with anti-avoidance provisions.

Income tax

The residence of the trustees of a discretionary trust determines the extent of the trustees' liability to income tax in respect of the trust's income. If all of the trustees are Irish resident, they will be liable to Irish income tax on the worldwide income of the trust. If none of the trustees are Irish resident, they will be liable to Irish income tax only on the Irish-source income of the trust. There is no specific legislation dealing with the position where some of the trustees are resident and some are not.

Trustees pay income tax at the standard rate and are not subject to the marginal rate. However, trustees are not entitled to personal credits and certain reliefs that are available to individuals. If income is accumulated in the trust by the trustees, a surcharge of 20% on the undistributed income arises to the extent that it has not been distributed within

5 Section 104 of CATCA 2003.

18 months of the year of assessment in which the income arises.[6]

Stamp duty

Stamp duty will arise in the normal course on any stampable instrument of transfer that the settlor executes to transfer assets to the trust or that the trustees execute on purchasing assets from third parties during the trust period. No stamp duty arises on the appointment by the trustees of assets to the beneficiaries of the trust.

Uses

Discretionary trusts are particularly useful in providing for young children, beneficiaries with disabilities or vulnerable adult beneficiaries in wills.

Young children

Clients with young children will often not wish them to inherit substantial assets at a young age. They would like their children to be established in their careers and their lives in general, so that they have developed a maturity and an understanding of financial matters, before they inherit anything of substance. In addition, when children are very young, it is difficult to anticipate what their future needs will be: some children may require more assistance than others.

The mechanism of a discretionary trust enables parents to adopt a wait-and-see approach. It enables them to choose individuals, whom they trust effectively to step into their shoes, to apply the trust fund for the benefit of their children and appoint the funds to them absolutely when they consider it appropriate.

As outlined above, a will that establishes a discretionary trust is generally accompanied by a letter of wishes setting out what the parents would like to happen with the trust fund. This is a very individual letter from the parent to the trustees. It may include, for example, that the trust fund should be divided equally between their children unless there is good reason for doing otherwise. It may specify the age at which they would like the children to benefit.

Given the level of discretion that the trustees can exercise, some clients will, in addition to appointing trustees, appoint a protector to provide some oversight of the trustees. This provides an additional layer of protection.

Taxation

As outlined above, a charge to CAT may arise for the children on receipt of an appointment from the trustees. If the appointment is made for the support, maintenance or education of the child, and both parents have died, the appointment may be exempt from CAT if the child is a minor, or is under 25 and in full-time education, or regardless of age is permanently incapacitated.[7] For the exemption to apply, the benefit must be considered to constitute normal expenditure having regard to the financial circumstances of the parent before his or her death.

The provisions of the support and maintenance exemption were recently considered by the Tax Appeals Commission (“the Commission”)[8] in the context of use of the exemption during the lifetime of a parent. It found that both support and maintenance denote some element of a requirement for need or upkeep in order for the exemption to apply. The Commission found that the purpose of the exemption was “to provide support and maintenance to a child that required financial assistance with ongoing living requirements and not to subsidise children who have visible means of supporting themselves”.

As outlined above, discretionary trust tax may arise when the youngest child attains 21 years of age, assuming that there is no interest in possession. It may be possible to appoint out funds to the older children before the youngest child turns 21 to minimise the liability that may arise.

6 Section 805 of the Taxes Consolidation Act 1997 (TCA 1997).

7 Section 82(4) of CATCA 2003.

8 14TACD2018.

Beneficiaries with disabilities

A discretionary trust is often the optimum method of providing for children or other beneficiaries with disabilities. Parents of children with disabilities face a number of difficult issues in seeking to make provision for their children. In most cases, the parents will have been the primary caregivers, and they will be anxious to ensure that the child will be looked after, not only from a financial perspective but also to ensure that their day-to-day living and emotional needs will be met.

Parents will be anxious to ensure that the persons caring for the child after their death will have sufficient resources and flexibility to deal with any changes in the circumstances of the child and to ensure that the child will be in a position to make, in so far as possible, his or her own choices.

It will often be very difficult to assess future needs, and there may not be obvious people who would be happy to act as primary caregivers. There will also be uncertainty on the role of the State in the future and on the impact that any provision may have on the benefits that the child may currently receive.

In dealing with the variables presented, the discretionary trust structure offers huge flexibility to adapt to a child's changing needs. It may also be possible, depending on the capacity of the child, for the child to be one of the trustees and thus to have an input into the decision-making process.

Taxation

A charge to CAT may arise on the appointment of funds to the incapacitated child. However, a benefit taken exclusively for the purpose of discharging qualifying expenses of an individual with a disability is exempt from CAT.[9] Qualifying medical expenses are defined as expenses relating to medical care, including the cost of maintenance in connection with medical care.

In guidance on the application of the exemption, Revenue has stated[10] that to qualify for the exemption:

> "[t]he gift or inheritance must be taken **exclusively** for the purpose of discharging qualifying expenses of the incapacitated person. In this regard it is the intention of the disponer providing the gift or inheritance that determines the availability of the exemption. In the absence of such an intention, it is not relevant that a beneficiary might decide, after receiving a gift or inheritance, to use it to discharge medical expenses [emphasis in original]."

However, in a recent decision in relation to the exemption,[11] the Commission found that it applied to the application of an inheritance by a beneficiary to the care of the children of the beneficiary without specific direction from the disponer to discharge such expenses. The Commission found that there is no requirement that the beneficiary's own expenses be discharged and that it was not necessary to provide evidence of the disponer's intentions.

An exemption from discretionary trust tax may arise where a discretionary trust is established:

- for the benefit of one or more individuals; and
- for the reason that such individual, or all such individuals, is or are, because of age or improvidence, or of a physical, mental or legal incapacity, incapable of managing that individual's or those individuals' affairs.[12]

9 Section 84 of CATCA 2003.

10 Revenue's Tax and Duty Manual – CAT Manual - Part 22

11 32TACD2019.

12 Section 17(1)(d) of CATCA 2003.

The exemption does not apply automatically. It is necessary to apply for the exemption when the trust is established and to furnish Revenue with a medical certificate from a doctor confirming that the child is incapable of managing his or her affairs for the relief to apply.

Trusts for vulnerable beneficiaries

A discretionary trust is a useful protection for adult beneficiaries who suffer from drug, alcohol, gambling or other addictions, or indeed are just poor at managing money. In such cases, tax considerations, in particular discretionary trust tax, are secondary to the desire to protect a vulnerable family member. Depending on the circumstances, it may be possible to claim the exemption from discretionary trust tax, as outlined above, on the basis that the individual is incapable of managing his or her affairs. Each case is decided on its own facts. For example, the authors understand that the relief has been granted in the past where an individual was suffering from alcoholism.

Fixed Trust

In a fixed trust, each beneficiary has a fixed entitlement to a specific share of or interest in the assets owned by the trust. For example, the trustees might hold property equally between children of the settlor to be paid to them upon reaching a particular age. A life interest trust is another example of a fixed interest trust, with the life tenant being entitled to the income from the trust for life, and the capital on the death of the life tenant being held for another beneficiary, generally referred to as the remainderman.

Tax implications

The tax implications of fixed trusts differ considerably depending on the nature of the fixed trust used. For example, a fixed trust under a will that provides that a child will inherit at age 25 will be treated differently depending on whether the trustees may accumulate income or are compelled to pay the income out to the beneficiary. We set out below the tax implications of a fixed trust under a will that enables a child to inherit at age 25, both with power to accumulate and without, to illustrate the differing tax treatment in this type of fixed trust.

Power to accumulate

Where the trustees have power to accumulate income, the trust is deemed to be a discretionary trust for CAT and income tax purposes.[13] On the child's 21st birthday, assuming that there are no other principal objects in the trust, discretionary trust levies will arise (6% on the child's 21st birthday and 1% per annum thereafter, albeit that 50% of the 6% levy will be refunded on the 25th birthday). On the child's 25th birthday, the child is deemed to inherit the asset at that date and is taxed accordingly. The child's tax-free group threshold is applied to the amount received, and the excess is subject to CAT at 33%. The difference between this trust and a discretionary trust, outlined above, is that the trustees do not have the flexibility to amend the trust to minimise levies and must therefore pay levies, even if the youngest child is mature at age 21.

In addition, the winding-up of the trust on the 25th birthday is a taxable event for CGT purposes, albeit that usually there is a credit available for the CAT paid (this credit would be lost if the child sold the chargeable assets received by him or her within two years[14]).

The trustees are assessed for income tax and CGT purposes on the income or gains made by the trust during the period in which the assets remain in trust. In addition, the 20% discretionary trust surcharge arises on income accumulated in the trust. The tax effect is therefore the same as for a discretionary trust, outlined above, although the trustees do not

13 Section 2(1) of CATCA 2003.

14 Section 104 of CATCA 2003.

have any discretion to retain funds from the child at age 25. To the extent that income is paid out, the child is assessed to tax on the income and can claim a credit in respect of tax paid by the trustees. The child is also treated as receiving an inheritance of the amount received, which is subject to CAT (in such a case, relief could be sought from Revenue to treat the value of the inheritance as net of income tax).

No power to accumulate

Where the trustees do not have power to accumulate income, the authors understand that it is Revenue's view[15] that for CAT purposes the child is deemed to inherit an interest in possession on the death of the parent. This inheritance is taxed as a limited interest calculated by subtracting from 25 the age of the child at the parent's death to arrive at a calculation of a period certain (and then applying the rules in Schedule 1, Part 1, paragraph 6, CATCA 2003, to arrive at the taxable value). The usual tax-free threshold is applied to the value received, and the balance is subject to inheritance tax at 33%. On the child's 25th birthday, the child is deemed for CAT purposes to inherit a further absolute interest in the trust fund at the value at that date of the trust fund. The child's earlier fixed interest is aggregated with the absolute interest now taken. The usual tax-free threshold is applied to the value received, and the balance is subject to inheritance tax at 33%. In effect, there is a double charge to CAT on the same assets in the trust.

The trustees are assessed for income tax and CGT purposes on the income or gains made by the trust during the period in which the assets remain in the fixed trust. The child is also assessed on the income and can claim a credit in respect of tax paid by the trustees.

Again, the winding-up of the trust on the 25th birthday is a taxable event for CGT purposes, albeit that usually there is a credit available for any CAT paid. This credit would be lost if the child sold the chargeable assets received by him or her within two years.[16]

The effect of this is that the typical fixed trust is a quite inefficient method, either because of the discretionary trust levies applying (without the benefit of the discretion) or because of the risk of double taxation for CAT. It does not afford real protection for a child should that child still be immature at the selected age.

Anti-avoidance

There are a number of anti-avoidance provisions that may apply in relation to trusts – for example, the transfer of assets abroad legislation – in addition to the general anti-avoidance provisions. These are complex provisions and are outside of the scope of this article.

Beneficial Ownership Regulations

The European Union (Anti-Money Laundering: Beneficial Ownership of Trusts) Regulations 2019 ("the Regulations"), introduced in January 2019, have set out new obligations on trustees of Irish trusts to disclose beneficial ownership information in relation to trusts. These obligations represent a significant development for trusts, their trustees and their beneficial owners.

Trust obligations

The Regulations oblige trustees to establish and maintain a beneficial ownership register in relation to trusts. The requirements apply to any trustee of an "express trust" (which is not defined or limited to exclude common commercial, employment and financial trust-based arrangements, such as security trusts, charitable trusts, pension schemes, real estate trusts, employee share schemes, and declarations of trusts appointing nominee shareholders) where:

15 This tax treatment is, however, uncertain as it rests on Revenue's interpretation of the legislation in light of the case of *Jacob (Brigid Kathleen) v Revenue Commissioners* [1984] 3 ITR 104, which was settled without fully determining the issue of value.

16 Section 104 of CATCA 2003.

- the trustee is resident in Ireland; or
- the trust is otherwise administered in Ireland.

A beneficial owner for the purposes of the Regulations is "any natural person(s) who ultimately owns or controls the customer and/or the natural person(s) on whose behalf a transaction or activity is being conducted" and includes:

- the settlor, the trustees, the protector (if any), the beneficiaries, or the class of persons in whose main interest the trust is established;
- any other natural person exercising ultimate control over the trust by means of direct or indirect ownership or by other means; and
- the manager/operator of the trust, if the trust is part of a collective investment undertaking.

A trustee of a trust that is within the scope of the Regulations must take all reasonable steps to obtain and hold adequate, accurate and current information in relation to the beneficial owner(s) of that trust, in order to reflect this in the trust's beneficial ownership register. The register of beneficial ownership is to be known as an "express trust (beneficial ownership) register" and must include the following information in relation to each natural person identified as a beneficial owner:

- name, date of birth, nationality and residential address;
- the date on which the person was entered into the register as a beneficial owner; and
- the date on which a person who has ceased to be a beneficial owner ceased to be such an owner.

It is unclear what actions will be considered a sufficient discharge of the obligation of trustees to take "all reasonable steps" to maintain and hold adequate, accurate and current information on the trust's beneficial ownership. The Regulations do not set out any particular steps that must be taken. However, trustees are required to keep records of the actions taken to identify the beneficial ownership of the trust and retain those records for a period of not less than five years after the date on which the final distribution under the trust is made.

Failure to comply with the Regulations is a criminal offence, which is liable on summary conviction to a Class A fine. A Class A fine has a maximum amount of €5,000.

Access to register and disclosure of information

The Regulations provide that access to the information recorded on the beneficial ownership register may be requested by the Revenue Commissioners or any "State competent authority", and trustees must provide the access in a timely manner. A "State competent authority", as defined, includes the Central Bank of Ireland, the Minister for Justice, Equality and Law Reform, and any other competent authorities prescribed by regulations made under the Criminal Justice (Money Laundering and Terrorist Financing) Act 2010.

A State competent authority may disclose the information in a beneficial ownership register to any corresponding competent authority of another EU Member State.

In addition, where the trustee of a trust enters into an occasional transaction with a person who is a designated person for anti-money-laundering purposes, or forms a business relationship with such person, the trustee must:

- inform the designated person in writing that it is acting as trustee; and
- on request from the designated person, provide the designated person with information identifying all of the beneficial owners of the trust.

The European Union's Fifth Anti-Money-Laundering Directive (Directive 2018/843, AMLD5) requires Member States to establish a central register or database to hold beneficial ownership information in respect of trusts irrespective of whether the trust generates a tax effect. The specified information on the central register must be accessible to certain permitted persons and bodies, which include:

- competent authorities and financial intelligence units;
- obliged entities;
- any natural or legal person who can demonstrate a "legitimate interest"; and
- any natural or legal person who files a written request in relation to a trust or similar legal arrangement that holds or owns a controlling interest in any corporate or other legal entity through direct or indirect ownership.

At the time of writing, Ireland has not yet established such a central register or database to hold beneficial ownership information in respect of trusts. AMLD5 required each EU Member State to establish a central register of beneficial ownership of trusts by 10 March 2020. However, it is understood that this legislation giving effect to AMLD5 is due to be published shortly.

Conclusion

As outlined above, trusts can be very useful tools for clients in a variety of circumstances. The taxation treatment of them can be complex and requires careful consideration before any trust structure is established. Discretionary trusts, in particular, can give great flexibility in providing for young children, beneficiaries with disabilities and vulnerable adult beneficiaries.