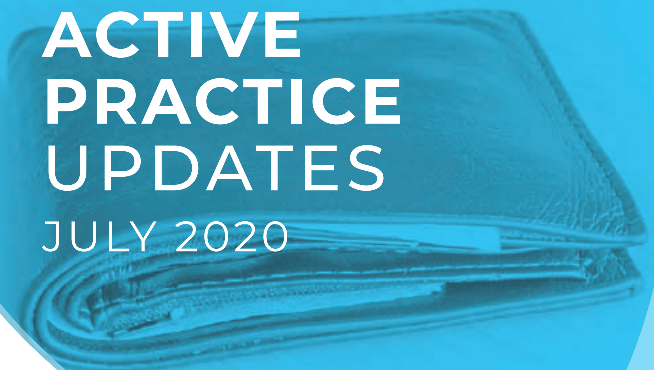

ACTIVE PRACTICE UPDATES

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THE McCAY PARTNERSHIP

Chartered Accountants

TRUSTS AND PASSING ON WEALTH

How to pass on wealth to the next generation.

There are many ways to reduce or eliminate the inheritance tax payable on your estate without using trusts.

But for some, especially if you are very wealthy, they may not be enough. For others, the control that trusts give over who benefits from your wealth, and how, is vital for estate planning.

WHAT IS A TRUST?

A trust is a legal construct in which you (the settlor) transfer assets to be managed by someone else (the trustee) for the benefit of another person (the beneficiary).

There can be more than one person in each role and sometimes one person may occupy more than one role. For inheritance tax planning purposes, the settlor must not also be a beneficiary of the trust.

In one typical estate planning scenario, you may be the settlor, you and your adult child may be the trustees, and your junior grandchildren the beneficiaries.

The settlor creates the trust and puts the assets into it. They choose both the trustees, the beneficiaries, and set the rules governing how the trustee can manage the trust in the deed.

The trustee takes nominal ownership of the property in the trust. They manage the assets in accordance with the trust deed and relevant trust and tax laws. They must act in the best interests of the beneficiary.

The beneficiary receives the proceeds from the trust (assets or income) in line with the trust deed and on the instruction of the trustees, who will act in the best interests of the beneficiary.

So, to summarise, you give up possession of the assets you put in a trust. But you choose the trustees and beneficiaries, and the rules that the trustees must follow.

In these key characteristics come the benefits – by not owning the assets they do not form part of your death estate after seven years, and therefore become exempt from inheritance tax on your estate (although they may face other charges).

And by setting rules and being one of the trustees, you retain real control over the future of the trust, who benefits from the assets, and how they are used.

MAIN TYPES OF TRUST

Trusts can be used beyond inheritance tax planning, and there are, indeed, many types of trust.

When it comes to trusts for the purposes of inheritance tax planning there are two main types: bare (also known as 'simple' or 'absolute') trusts and discretionary trusts.

There are variations on discretionary trusts to achieve specific goals. Examples of these are interest-in-possession trusts, loan trusts and discounted gifts trusts.

TAX-PLANNING SCENARIOS

If you are familiar with some of the basics of inheritance tax planning, you'll know that one of the main ways to reduce liability is to gift assets to beneficiaries before you die.

It's simple – as long as you give up all ownership and associated rights, the gift becomes exempt from inheritance tax after seven years (and the liability reduces on a sliding scale during those seven years).

This provision may be perfect for you by itself. However, depending on your family circumstances, gifting may expose your assets to unintended and/or unwanted consequences as you will need to accept the loss of control over the asset gifted.

You can perhaps use your imagination to speculate, but some scenarios include:

- You gift cash to your adult son who, unbeknown to you, has debts. His creditors claim all the money.
- You gift a house to your married daughter who goes on to separate from her husband. He gets half the house's value in the divorce proceedings.
- You want to pass money directly to your grandchildren, but they access it during their adolescence and fritter it away.

In all of these circumstances, trusts offer you protection.

BARE TRUSTS

Bare trusts are the simplest of trusts. The beneficiaries are chosen at the outset and cannot be changed. Most commonly these are used when passing money from parents to children, and the parents act as trustees.

The assets put into the trust are treated as a gift for inheritance tax purposes, so after seven years there would be no tax to pay.

When the children turn 18 (or 16 in Scotland), the bare trust does not exist any more and the assets belong solely to the beneficiaries. Because of this, they may be too simple a solution if significant sums are being gifted.

If a parent has settled money into a bare trust for a child and it produces more than £100 in income per annum, be wary that the income would be taxed as if it were the parents'.

Example

John and Laura are in their late 60s and have five young grandchildren. They all live in England.

They would like to give them money when they reach adulthood, either for a house deposit or some other purpose, and they have faith they will be brought up not to squander it.

John and Laura are aware that gifting money now, rather than when they are in their 80s, gives them a better chance of surviving seven years and removing assets from the scope of inheritance tax.

They gift £10,000 each into five bare trusts with the five grandchildren as beneficiaries. Their parents are trustees and are responsible for saving or investing the money. When the children turn 18, the money is available to them.

DISCRETIONARY TRUSTS

A discretionary trust is more like the classic trust, where the settlor prescribes rules that the trustees must follow. There must be at least two trustees and you can have as many beneficiaries as you like.

A discretionary trust can allow you to retain some control over how your assets are used. Rather than assets being accessible merely by virtue of being 18 or older, you can specify who benefits and how – for instance drawing an annual income or benefiting from the use of an asset without actually owning it.

This allows you to protect the underlying assets from a wide range of risks like those we mentioned earlier – divorce, bankruptcy, or impulsive spending.

TAXING DISCRETIONARY TRUSTS

Unfortunately, the level of control on offer does come with some downsides.

More complicated trusts will incur more costs to run, for instance from adviser fees. And discretionary trusts also have their own tax regime which your assets may be exposed to. These include capital gains tax, income tax (including tax on dividends), and inheritance tax.

Yes, inheritance tax may come into play when you set up a discretionary trust and at key milestones of the trust's existence.

As with individual inheritance tax, there are rates and allowances. So you can transfer up to £325,000 into a discretionary trust in a seven-year period and benefit from the nil-rate band.

Anything above this is chargeable at 20% on entry into the trust, while a 10-year charge of up to 6% on any excess of the nil-rate band can apply as well, plus an exit charge of up to 6%.

Taxation of trusts has become more aggressive in recent years, and the rates of capital gains, income and dividend tax are generally not favourable.

However, with careful planning, timing and the right investment mix, tax liabilities can still be managed.

So for wealthy individuals for whom control over the assets that they are passing to the next generation is important, trusts will often play a significant role.

As you can see, it is easy to make a false step when you go down the trust route, so it is best to seek professional advice when setting up trusts.

Speak to us about trusts and estate planning.