Let's talk about Inheritance Tax

Trusts

What is a Trust ?

A trust allows the transfer of ownership of assets, for the benefit of one more beneficiaries, without relinquishing overall control of those assets. These assets could be anything from stocks and shares, land, money or buildings. Trusts are not a new concept and their history can be traced back to medieval England, when crusading knights would leave their property to be managed by others in their absence.

A trust is basically a legal arrangement normally created by a document, the trust deed. The trust deed states the purpose of the trust, who is responsible for managing the trust (the trustees) and the potential beneficiaries who will eventually benefit from the assets in the trust. The trustees become legally responsible for holding the assets and for running the trust, following the wishes of the person who created the trust (the settlor).

Therefore, trusts are often used in Inheritance Tax Planning to allow the transfer of assets from someone's estate without the loss of control that an outright gift would bring. Care has to be taken to ensure that the person transferring the asset (the settlor) does not then continue to enjoy the benefits of the asset. This is known as a Gift with Reservation and HMRC take a dim view of such transactions.

So what are the benefits of creating a trust?

As we have seen, creating a trust allows people to retain control over their gifted assets. This could be such matters as distributing assets to certain beneficiaries at certain times.

This can provide peace of mind over the certainty of people's affairs, knowing that the trust assets will be distributed in accordance with their wishes. For instance, this could help to protect a legacy in the event of future generational marital disputes, or to avoid gifting money to grandchildren that they may not spend prudently.

The trust should not form part of the estate, meaning that trusts can be established and kept confidential. This also means that the assets will be protected in the event of bankruptcy.

There is also the benefit of mitigating Inheritance Tax, due to the many ways trusts can be used in such planning.

What are the common types of Trust used?

There are lots of different trusts out there, using all sorts of names. They tend to be a variation of the following most common:

Discretionary Trusts

This is a type of arrangement where no beneficiary is absolutely entitled to the asset in the form or income or capital. The trustees have absolute discretion as to how and when to distribute to any beneficiary (within the class of beneficiaries stipulated in the deed). This type of trust tends to be used when the settlor wishes to give the trustees the most control over when and to whom to distribute.

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Interest in Possession Trusts

As the name suggests, this trust allows a beneficiary/beneficiaries to enjoy the right to the trust property or and income generated by the trust. This type of beneficiary is known as the life tenant (or life renter in Scotland) and are automatically entitled to the trust income but not the capital. As an example, the life renter could for instance benefit from living rent free in a trust owned residential property without owning it themselves.

Absolute Trust

Sometimes known as a bare trust, this is a trust where the beneficiary has the right to the trust capital and the income. Absolute trusts can be used to make gifts to minor children for instance or to a beneficiary whom the settlor is certain they want to benefit.

Sounds great, but what about tax?

The taxation of trusts can be complicated and it is always best to seek professional advice.

The creation of a discretionary trust is known as a Chargeable Lifetime Transfer, which means that there could be an immediate charge of 20% if the value of the gift exceeds the nil rate band of £325,000. Further periodic charges may be liable on the tenth anniversary of the trust (and every 10th anniversary thereafter) and once capital leaves the trust. Interest in Possession Trusts created after 22 March 2006 are taxed like Discretionary Trusts.

Absolute/Bare trusts work differently as the beneficiary is entitled to the capital and income. Therefore, the beneficiary pays the tax, as the gift is essentially theirs immediately. Any gift into such a trust is a deemed as a Potentially Exempt Transfer (see previous article).

There are also considerations for gifting into trust, where the settlor does not survive for 7 years after settling the trust.

Seems very complicated. How can all this help with Inheritance Tax planning?

The jargon used can be very complicated and perhaps even intimidating. However, the questions to consider are quite straightforward for those thinking of IHT planning using trusts. Basically, the questions to consider before gifting sums away into trust for others are:

1. Do I require access to income from the investment?
2. Do I require access to capital?
3. Am I prepared to give up all access to the investment?

Once these questions have been addressed, professional planning can help to formulate a strategy.

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OK, can you explain how?

All individual circumstances are, well, individual, so no one solution will fit all scenarios.

The following are examples of how some trusts work on practice, either on an Absolute/Bare or Discretionary basis:

- Those requiring access to income may consider a Discounted Gift Trust. (DGT). In a DGT, income is normally provided by means of a series of pre-set capital payments back to the settlor of the trust.
- Those requiring access to capital could consider a Loan Trust. The settlor basically loans money to the trust and can access their original capital at any point. Any growth in the investment will not form part of their estate. The outstanding loan does however remain in the settlor’s estate for IHT purposes.
- Those not requiring access to capital or income could consider a Gift Trust. Once this trust has been established, the settlor cannot access it.

The act of gifting assets into Trust reduces the estate of the settlor, due to the change in ownership of the asset from the settlor to the trust. Therefore, the settlor’s overall exposure to an Inheritance tax liability can be reduced.

There are considerations to be made however as to the timing, amount and order of gifting into trusts to ensure that any potential Inheritance Tax liability is minimised or mitigated. Therefore, it is important to seek professional advice.

Summary

Trusts can be used extremely effectively in Inheritance Tax planning. Although their technical nature can be off-putting, their actual purpose is relatively straightforward. Those wishing to gift money into trust may still retain an element of access to the capital or income, as well as not relinquishing control.

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