Deloitte.
Private

Briefing document

Lifetime trusts for grandchildren

Introduction
There are various types of trust which may be suitable when establishing a trust for the benefit of grandchildren during lifetime. The choice of trust will depend on the circumstances and amounts involved.

The tax regime for trusts changed significantly following the Finance Act 2006. Accumulation & maintenance trusts and interest in possession trusts, both of which were widely used at the time of the Finance Act 2006, were particularly affected by the changes. Therefore we suggest that advice is taken in relation to these types of trust where they already existed when the 2006 changes took effect.

The types of trust that can now be created to benefit children during a grandparent's lifetime include:

- Discretionary trusts
- Interest in possession trusts
- Bare trusts

In all of the situations described below it has been assumed that the settlor and his or her spouse cannot benefit in any way under the terms of the trusts concerned. This applies equally where the settlor has a registered civil partner. For these purposes we have assumed that if the settlor has minor dependent children as well as grandchildren, the settlor's minor children cannot benefit under the terms of the trusts. Where this is not the case, the tax position may be radically different from that set out.

It has also been assumed that all of the individuals who may add property to or benefit from a trust will be UK resident and domiciled, and that the trust will be UK resident. The tax position may differ significantly if any or all of the individuals are non-UK resident or non-UK domiciled, or if the trust is non-UK resident.

Throughout this note, references to a spouse should be taken to include references to a registered civil partner.

Discretionary trusts
Under a discretionary trust no beneficiary has any right to income or capital. A discretionary beneficiary merely has a right to be considered by the trustees as a potential object of their discretionary powers. The trustees have considerable flexibility as to whom amongst the class of beneficiaries they decide to confer any benefit, as to either income or capital, or both. Normally the settlor of such a trust will send a letter of wishes to the trustees providing guidance to them as to how he or she would wish them to exercise their discretion. Such an expression of wishes cannot be binding on the trustees, as otherwise the status of the trust as discretionary would be compromised.

Inheritance Tax (IHT)
As beneficiaries have no right to income or capital, there is no charge to IHT on the value of the trust fund on the death of beneficiaries of a discretionary trust.

A gift into a discretionary trust is a chargeable lifetime transfer for IHT purposes, but to the extent that the value being gifted into trust (other than property qualifying for relief or exemption) does not exceed the amount of the nil rate band available to the donor, no IHT will be payable. Any excess value over the nil rate band will be taxed immediately at the lifetime rate of 20%.

A married couple could therefore settle up to £650,000 (2020/21) between them. Gifts within any unused annual exemptions from the current and previous year, some business property (e.g. shares in an unquoted trading company) and certain agricultural property may also be transferred free of an immediate IHT charge.

A charge to tax on the trustees arises on every tenth anniversary of the making of the settlement and when assets leave the trust. The applicable IHT rates can be very low, particularly when compared with tax rates that apply to some individuals on death. The maximum ten-year charge is 6% of the value of the trust fund at the anniversary date.

Income tax

For UK resident discretionary trusts, the first £1,000 of income received will be taxed at the basic rate of 20% or dividend rate of 7.5% (for 2020/21). Income over this amount will suffer the rate applicable to trusts, which in 2020/21 is 38.1% on dividends and 45% on all other income.

Beneficiaries of the trust receive income distributions net of a 45% tax credit. Where the beneficiary pays tax at a rate lower than 45%, or where the income distribution is within the beneficiary's personal allowance, he or she can claim a repayment of tax. The trustees must pay sufficient tax to cover the 45% tax credit that attaches to any income distribution they make. This can involve the trustees paying additional tax when they make distributions to beneficiaries. Trusts do not benefit from the dividend or savings nil rate bands.

Capital Gains Tax (CGT)

Capital gains will usually arise when gifts are made into trust (unless exempt assets such as cash are gifted). These gains can be heldover to the trustees (whether or not business assets are involved) so that the trustees would acquire the asset at the donor's base cost for CGT purposes. To the extent that trustees realise capital gains in excess of the annual exemption, trustees pay CGT at a rate of 20% on most assets and 28% on residential property and, if applicable, carried interest in private equity structures. The annual exemption for trusts is currently £6,150 (for 2020/21). However, this is subject to anti-avoidance provisions to prevent multiple settlements being created in order to benefit from multiple annual exemptions.

Interest In Possession (IIP) trusts

This type of trust was usually used to confer benefits on adult children or grandchildren, albeit its use following the Finance Act 2006 has become less common than previously. The beneficiaries will normally be entitled to the income for life as of right, and the trustees will have the power to appoint capital to a beneficiary out of the fund from which he or she is receiving the income. Further trusts will usually follow for the benefit of a surviving spouse and children.

More flexible IIPs will often contain an overriding power for the trustees to make appointments to a wider class of beneficiaries.

Inheritance Tax (IHT)

Any gifts into an existing IIP trust or the establishment of a new IIP trust follows the same IHT treatment as that for a discretionary trust. Therefore, depending on the value transferred into a settlement, the type of assets settled and previous gifts made, there is an IHT charge on creation and further charges every ten years and on distribution of assets from the trust.

Income tax

An IIP trust has income tax transparency, meaning that income will be assessed on the beneficiary at his or her marginal tax rate (i.e. the tax rate depends on the beneficiary's income level, which will determine the tax rate applicable to the trust income). The trust beneficiary is chargeable to income tax at dividend rates on dividend income received by the trustees; this may be beneficial in comparison to the tax position of discretionary trusts that receive dividend income.

Capital Gains Tax (CGT)

As with discretionary trusts, any capital gains made on gifting assets to the trust can be heldover, provided the trust is not settlor interested. Gains arising to the trustees are taxable on them, as outlined for discretionary trusts above.

Bare trusts

A bare trust is a trust where the trustees hold the capital and income of the trust fund absolutely for the beneficiary in question. The beneficiary is usually a minor or a person with a disability who is unable to give a valid receipt for the trust monies to the trustees.

Due to the tax treatment of bare trusts and because the beneficiary will become entitled absolutely to the trust fund at 18 years of age, this type of trust may not always be appropriate.

Whilst the trust remains in existence, the trustees are able to pay out capital and apply income for the maintenance, education and benefit of the beneficiary.

The minor beneficiary will become absolutely entitled to the trust capital and any accrued (and arising) income on attaining the age of 18 years.

Inheritance Tax (IHT)
Gifts into a bare trust qualify as Potentially Exempt Transfers (PETs), so that no IHT is due where the donor survives making the gift by seven years.

On the death of a beneficiary under a bare trust, the value of his or her interest under the trust comprises part of his or her estate for IHT purposes.

Income tax
Any income arising under a bare trust will be taxable on the beneficiary, whose own personal allowance and tax rate(s) will apply.

Capital Gains Tax (CGT)
A gift into a bare trust will be a disposal for CGT purposes by the donor and unless the gift is cash, the amount of any inherent gain on the asset to be gifted into trust will need to be reviewed as a CGT charge may arise.

If the asset is a business asset, any capital gain can be heldover to the trustees of the trust provided the statutory rules are met in full. The trustees would then acquire the asset at the donor's base cost for CGT purposes.

Registration with HMRC
Trustees of 'relevant trusts' are required to obtain and retain information in order to comply with UK legislation which was introduced to order to comply with the European Union's Fourth Money Laundering Directive (4MLD). Furthermore, 'relevant taxable trusts' with a 'UK tax consequence' must register and provide 'beneficial ownership information' to HMRC for inclusion on a non-publicly available online trust beneficial ownership register.

In addition to disclosing trust beneficial ownership information, the register must also be used by trusts and estates in order to notify HMRC of chargeability to tax and receive a Unique Taxpayer Reference (UTR).

The trust register is in the process of being amended in order to comply with the European Union's Fifth Money Laundering Directive (5MLD). The range of trusts required to register will expand to include most UK trusts that do not incur a UK tax liability and non-UK trusts that enter into certain business relationships with UK persons or which acquire UK land.

Find out more...
This note reflects the law in force as at 28 April 2020. Please be aware that it does not cover all aspects of this subject. To find out more about any aspect of the above, please discuss with your usual Deloitte contact. If you do not have a usual contact, please contact Patricia Mock (pmock@deloitte.co.uk).

For further information visit our website at www.deloitte.co.uk.