EDUCATION FEES PLANNING CASE STUDY

Using an investment bond with a discretionary gift trust, together with a deed to appoint absolute beneficial interest, can provide flexible tax planning for your clients if they want to set up a trust fund for their grandchildren.

If your client wants to set up a trust fund to help with education fees planning for their grandchildren, they may want to consider using a discretionary gift trust. This type of trust is flexible and allows for a wide range of potential beneficiaries. It also allows the trustees to control which of those potential beneficiaries actually receive distributions from the trust fund, how much they receive and when. However, one of the drawbacks of a discretionary trust is the way in which any chargeable gains on the bond may be taxed. If the trustees take money from the bond to give to a beneficiary during your client's lifetime, any resulting chargeable gain will be assessed on any UK resident settlor (your client) at their highest marginal rate of income tax. In any tax year after your client dies, any chargeable gains may be assessed on the UK-resident trustees at the trust's rate of tax, which is currently 45%.

An alternative would be to use an absolute (bare) gift trust where any tax on payments from the bond will ordinarily be assessed against the beneficiaries*. This could be useful, as your client's grandchildren are likely to have a preferable tax position to your client, or the trustees. However, the beneficiaries of an absolute trust, and their share of the trust fund, are fixed at the start and they can claim their full share as soon as they reach age 18. This limits the control and flexibility available to your client and their chosen trustees.

*Unless the beneficiary is the child of the person creating the trust and is a minor. In that case, under the parental settlement rules, the creator of the trust (the parent) is liable to the tax on any gains in excess of £100.

There is a way you can help your client combine the flexibility and control of a discretionary trust and the potential tax efficiency of an absolute trust. The fictitious case study over the following pages illustrates how this can be achieved.

The information in this document is based on our interpretation of law and taxation practice in the UK, Isle of Man and Ireland as at 1 August 2021. Tax rules may change and depend on individual circumstances.

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WEALTH SOLUTIONS

CASE STUDY - MIKE

Mike is 67 and wants to put aside £200,000 for the benefit of his grandchildren, to help pay for their education fees. Mike would also like to take steps to reduce the impact of Inheritance Tax on the amount he leaves to his family when he dies. He's certain that he will not need access to this money in the future.

Mike may wish to consider investing this money using a gift trust in combination with a bond.

WHY USE A GIFT TRUST?

If Mike invests £200,000 into a gift trust from which he cannot benefit, that money will be treated as being outside of his estate after seven years. If Mike dies before seven years then this will create a failed transfer and IHT may be payable as a result. The failed transfer will also reduce the amount of IHT nil rate band* available to be used against other assets at death. Any growth on this investment will be outside of his estate immediately.

WHY USE A BOND?

An investment bond can be a tax-efficient solution for many trustee investments, as it is a non-income producing asset. This means income tax will only be due on the bond when a chargeable event gain arises. Chargeable events include, but are not limited to:

› withdrawals from the bond that exceed the 5% annual tax-deferred allowance

› surrender of the bond or any of the individual policy segments.

*IHT is paid if a person's estate (their property, money and possessions) is worth more than £325,000 when they pass away. This is called the 'Inheritance Tax threshold' or 'nil rate band'. The nil rate band will remain at this level until at least April 2026. There is also an IHT residence nil rate band that will broadly apply where a person's home, or a share of it, is left to direct descendants. There are also complex 'downsizing' rules which allow certain estates to still benefit when a home was disposed of, or where a smaller home was purchased on or after 8 July 2015. The maximum amount of this residence band is £175,000 for 2021/22. It is tapered away for estates valued over £2 million. For both the 'standard' nil rate band and the residence nil rate band, any unused amount will be transferable to a spouse or civil partner. The rate of IHT is currently 40% on anything above this threshold. The rate may be reduced to 36% if 10% or more of the net estate is left to charity. The rate of IHT and the nil rate band may be subject to change.

Mike has two grandchildren: Thomas, who is 3 years old, and Jessica, who is 1. Mike wants the trust fund to benefit them as well as any other grandchildren that might be born in the future.

Mike can achieve this flexibility and control by combining one of our bonds with our **Discretionary Trust (where the settlor cannot be a beneficiary):**

› The classes of potential beneficiary can include any grandchildren, including those born after the start of the trust

› The potential beneficiaries of a discretionary trust are not specifically entitled to anything from the trust fund and Mike's chosen trustees have control over the distribution of benefits, allowing them to decide when, and how much, to distribute to the chosen beneficiaries

› Mike can give his trustees a letter of wishes, asking them to consider distributing benefits in line with his intentions

› Mike can appoint himself as one of the trustees at the start of the trust, meaning he can have a direct influence over how the trust fund is used during his lifetime (as long as he does not benefit from it).

AWI PR 0008 | 11/22

WHAT TO BEAR IN MIND WHEN CONSIDERING USING A DISCRETIONARY GIFT TRUST

The gift Mike makes into the discretionary trust is a chargeable lifetime transfer (CLT), which will fall out of charge after 7 years. However, the trust may also be liable to IHT charges:

› when it is set up

› at each 10 year anniversary

› when assets are transferred out of the trust.

An IHT charge will occur when the trust is set up if Mike's CLT, combined with any other CLTs he has made in the last 7 years, exceeds the nil rate band*.

In this case, where he is intending to gift £200,000 and has made no other gifts in the previous 7 years, Mike will not need to worry about an immediate inheritance tax charge.

*The nil rate band for the 2021/22 tax year is £325,000, or £650,000 for married couples/civil partners who make a joint gift.

Though Mike prefers the flexibility of a discretionary trust, he doesn't like the fact that any chargeable event gains on the bond may be taxable against him or his trustees.

As the settlor, Mike may be liable to income tax on any chargeable event gains on the bond during his lifetime. After Mike's death, if his trustees are UK resident they may be liable to the tax on any chargeable gains, at the trust's rate of tax (currently 45%). However, it can be tax-efficient to have any chargeable gains assessed against the beneficiaries if their personal income tax position is preferable. This can be achieved by one of two methods:

IF THE BENEFICIARY IS OVER 18: ASSIGNMENT

› The trustees can assign individual policy segments to the beneficiaries immediately before those segments are cashed in (surrendered)

› Any chargeable event gain on the surrender of those segments is then assessed against the assignee (the beneficiary)

› However, **this method is not possible if the beneficiaries are under 18**, as they cannot legally own the segments.

IF THE BENEFICIARY IS UNDER 18: APPOINTMENT OF BENEFICIAL INTEREST

› The trustees can use a **Deed of Appointment of Absolute Beneficial Interest Under Trust** to appoint individual segments from the bond to a beneficiary who is under 18 immediately before they are surrendered

› The chosen segments remain held under the existing trust, but the appointment causes those segments to be treated as if they are held under absolute trust. Any chargeable event gain on the surrender of those segments is then assessed against the beneficiary*.

*This does not apply if the beneficiary is the minor child of the person creating the trust. In that case, under the parental settlement rules, the creator of the trust (the parent) is liable to the tax on any gains in excess of £100.

After considering his options with his financial adviser, Mike decides to go ahead, investing £200,000 in an Utmost bond and gifting the bond into our 'Discretionary Trust (Settlor cannot be a Beneficiary)'. The bond is segmented into 100 identical policy segments.

…9 years later his grandson Thomas is 12 and some money is needed from the trust fund to pay his school fees. By this time the bond has grown in value to £300,000. The trustees decide to make a distribution of 5 segments (£15,000) to help pay Thomas's fees.

The trustees would like the chargeable event gain on this distribution to be assessed against Thomas. To achieve this, the trustees can appoint 5 segments for Thomas's absolute benefit, using our **Deed of Appointment of Absolute Beneficial Interest Under Trust** and immediately surrender them.

The resulting £15,000 segment surrender and chargeable gain of £5,000 (the growth) will then be assessed against Thomas, as the absolute beneficiary. This gain would currently be covered by his Personal Allowance of £12,570 (2021/22) (assuming no other income from any source) so, in this case, no tax would be payable.

SUMMARY

Mike and the trustees have been able to use the flexibility of a discretionary trust and distribute part of the trust fund to a beneficiary who is under 18.

By providing for his grandchildren in this way:

› Mike's potential IHT liability has been reduced

› He has not incurred any immediate, periodic or exit IHT charges on his gift*

› The remainder of the trust fund can be used for the benefit of any of the potential beneficiaries and the trustees are able to take account of any change in circumstances before making further distributions

› Using a bond held under a discretionary gift trust, together with a deed to appoint absolute beneficial interest, Mike has been able to achieve all of this without having the investment gains assessed against himself or the trustees.

*Periodic or exit charges will depend on the size of the trust fund and the nil rate band at the time of the periodic charge or when monies are subsequently distributed.

Our bonds are split into identical policy segments. Any policy segments that have been appointed to beneficiaries cannot ordinarily be managed differently to the other segments in the bond in terms of any future withdrawals and the linked investments. Therefore it is important that the segments are surrendered, using a **Withdrawal or Surrender Form**, immediately after the appointment.

The values in the example on this page are for illustration purposes only. The value of the bond can go down as well as up and the policyholder(s) may get back less than originally invested.

Investment bonds are designed as medium to long term investments meaning at least 5 to 10 years or longer.

AWI PR 0008 | 11/22

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