

Lifetime Settlements and Trusts

What are they, what purposes do they perform and what is their tax treatment?

Settlements (often called "Trusts") are all about protecting, preserving and enhancing the wealth of a family. They may achieve these objectives in a variety of ways, which we will summarise later. First, some basic definitions relating to lifetime settlements; this leaflet does not deal with trusts established by wills or intestacies..

What is a Settlement?

A Settlement is established when a person (the Settlor) transfers assets to Trustees for the benefit of other people (the Beneficiaries).

Once settled, the assets no longer belong to the Settlor and in most (but not all) cases he or she may not use them or benefit from them again. Where that future exclusion from benefit applies, nothing should be given into Settlement unless the Settlor is entirely satisfied that his or her resources will be adequate in the future, without recourse to the assets in question.

Types of trust

The most common types of Settlement can be briefly summarized as follows, with the relevant tax rules; the detailed provisions are often complex. The taxes are Inheritance Tax ("IHT"), Capital Gains Tax ("CGT"), Income Tax ("IT") and Pre-owned assets Tax ("POAT").

Most Settlements are benign in terms of Stamp Duty Land Tax ("SDLT"), but care is needed.

1. Bare trust

The Trustee holds the assets for the Beneficiary (usually a child under 18, but since Finance Act 2006 also frequently an adult) "absolutely", with no conditions. This is akin to a nomineehip.

Tax	<i>Basic tax position</i>
IHT	The gift into the trust, however large, is a potentially exempt transfer ("PET") and falls out of account after seven years. There can be no immediate IHT charge, as there is with other types – see below. The assets belong to the Beneficiary, and are taxed fully on the Beneficiary's death.
CGT	The assets belong to the Beneficiary, and are taxed fully, but a single person's annual allowance will be available in full.
IT	The assets belong to the Beneficiary, and are taxed as part of his or her income, but a single person's annual personal allowance will be available in full. However, if the donor is the parent of the Beneficiary, the income will be taxed as the donor's.

2. Interest in Possession Settlement

This type of trust creates a "life interest" otherwise known as an "interest in possession", in favour of a beneficiary, referred to as the "Life Tenant". The Life Tenant is entitled to the income produced by the trust assets as it arises; or instead, to use or occupy the assets (such as a residential property) personally.

This technique is useful if the Settlor wants to prevent the object of his generosity, the Life Tenant, from frittering away the capital, which might happen with a direct gift. Indeed, the Life Tenant may be further sheltered, by giving him a "protective" life interest; if he tries to sell, give away or mortgage his right to income from the trust, he is automatically prevented from doing so.

The trust might be made even more flexible, by the insertion of provisions which would allow the trustees to vary the rights of the Beneficiaries without their consent. Such provisions can be powerful tax planning tools, or useful in the event of divorce or drug/alcohol dependencies, bankruptcy etc.

Tax	Basic tax position
IHT	<p>Following Finance Act 2006, the gift into Settlement is a "Chargeable Transfer". Tax is payable on creation of the Settlement, to the extent that the value transferred exceeds the nil rate band of the Settlor. The rate is 20%, and if the Settlor then dies less than seven years from the date of the gift, an additional 20% becomes payable. Where the death occurs between three and seven years after gift, taper relief will reduce the rate of tax.</p> <p>The value of the chargeable transfer is washed out of the estate after seven years, giving the opportunity to make further gifts.</p> <p>For interests in possession existing as at 21st March 2006 – on the death of the Life Tenant, the value of the Trust Fund is aggregated with his or her own free estate, and charged to IHT at the full rate, 40%.</p> <p>For interests in possession arising after 21st March 2006 – the death of the Life Tenant has no effect, but instead during the life of the Trust, there is a periodic charge to IHT every ten years; the rules are complex, but in general the rate of IHT will not exceed 6% every ten years. When assets are transferred out of the Settlement, whether to a Beneficiary or to another trust, an exit charge is payable at up to 6% again.</p> <p>All these charges to IHT can be avoided by choice of appropriate assets either to gift in at outset, or to invest in within the Settlement. Shares in private trading companies are a favourite asset type, qualifying for total exemption from IHT via business property relief, if the relevant conditions are met. Likewise farms and woodlands which may qualify for agricultural property relief.</p>
CGT	<p>CGT is payable by the Settlor on the assets gifted into the Settlement, assuming they show a gain compared with original cost plus indexation to April 1998. Taper relief may reduce the tax. The Settlor's annual exemption is available. However, an election can be made to defer the tax by holding over into the Settlement; this applies to all forms of asset, not just agricultural and business-related assets.</p> <p>During the life of the Trust, when the Trustees sell assets at a gain, CGT is payable from the Trust Fund, the annual exemption available to the Trustees usually being one half the normal annual sum. The rate of CGT is 40%. Where gains have been held over, the gain is calculated by reference to the Settlor's original cost.</p> <p>When assets are transferred out of the Settlement, whether to a Beneficiary or to another trust, CGT is payable at 40% on the notional gain made. Sometimes, CGT can be avoided by using the powers contained in a well-drawn Settlement Deed, to change the trusts affecting the assets without actually moving them out of settlement and creating a new one. Alternatively, an election can be made to defer the tax by holding over into the hands of the recipient.</p>
IT	<p>The Trustees receive their income either after deduction of basic rate tax, or gross (in which case they then pay basic rate tax on it) - they have no personal allowance. The Life Tenant will pay additional tax if he or she is a higher rate Income Tax payer, and will apply his or her own annual personal allowance.</p>

3. Discretionary Settlement

This type of trust creates considerable flexibility for the future. The Settlement deed does not set out specific trusts, but contains very wide powers and discretions for the Trustees to make up their minds as the years pass, as to who will be Beneficiaries and what they will receive, whether from capital or income. Whilst an initial class of potential beneficiaries of the Settlement will be defined, there is often a power for the Trustees to add to the list.

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IT	<p>The Trustees pay Income Tax at the special rate of 40% on all trust income - they have no personal allowance. Income received will have been taxed at a lower rate, depending on its nature; so the Trustees pay the shortfall each tax year. The tax paid is added to a "pool" of tax for use in future discretionary distributions of income to beneficiaries. However, the 10% tax credit associated with dividend income is not added to the pool.</p> <p>When income is paid to a Beneficiary under the Trustees' discretion, the Trustees can fund the extra tax (to make it up to 40%) from the accumulated tax pool. If the whole of the trust income consists of dividends, and all the income is distributed, the pool will become exhausted because the tax added to it excludes dividend tax credit. Thereafter, the Trustees will usually have to limit income distributions to 66% of the net dividends actually received.</p> <p>The Beneficiary may be able to reclaim some of the 40% tax paid, but will pay additional tax if he is a higher rate Income Tax payer. However, to the extent that dividends were included in the income, the dividend tax credit element of the 40% tax is <u>not</u> available for reclaim.</p>
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4. Accumulation & Maintenance Settlement ("A & M Settlement")

This was a special type of discretionary settlement, available only for limited types of Beneficiaries and favoured in tax treatment. With effect from 22nd March 2006, the special tax treatment ceased and it is generally unlikely that such settlements will be created in the future.

Many A & M Settlements exist, however, and special transitional rules apply to them until 5th April 2008. Trustees must consider what they should do, in all cases, since inaction will lead to the imposition of the tax regime applicable to Discretionary Settlements (outlined above) if nothing is done.

Tax Planning points:

1. If IHT becomes payable because of death within seven years following a gift into Settlement, nevertheless the value of the gift is fixed at the value at the time it was made. Any growth in value between the date of gift and the date of death escapes IHT. This is the so-called "value freezing" benefit of gifting assets. Indeed, if the value of the assets gifted is lower at the subsequent date of death than it was at the date of the gift, the tax is payable by reference to the date of death value.
2. Insurance on any liability to IHT can be taken out, to cover the possibility of death within seven years.
3. It is important to weigh up on the one hand the *possible* IHT savings by way of a gift into Settlement if the donor survives long enough, with on the other hand the *definite* loss of wash-out of Capital Gains on death. Beware the "double whammy" of full IHT (because the donor died within three years say) plus full CGT on sale (which would have been nil if the gift had not been made and the donor had still owned the asset at death).
4. IHT will be at 40% on the value of the asset, whilst CGT will be at 40% of the gain implicit in the value of the asset, after indexation and usually reduced by taper relief. Sometimes, virtually the whole of the value of an asset is gain, when the two taxes can become almost equal.
5. A gift into settlement starts a new CGT taper relief clock ticking, and all previously accrued taper relief is lost. If the asset proposed for gift is likely to be sold within a short time scale (2 years or so for business assets, 10 years or thereabouts for other assets), it will not have been held long enough to qualify for the fully tapered CGT rate.

6. If the Settlor or his or her spouse have an interest under any Settlement they make, they will usually be fully taxed to both CGT and IHT as though they still owned the assets.
7. In the case of a parent's Settlement for his or her own children whilst under 18, the Settlor will pay IT at his marginal rate on all trust income used for that child's benefit. For CGT, different rules apply, in that all gains will be taxed on the Settlor however small the benefit paid to any such children. This change applies to all Settlements in existence on 21st April 2006 – and will catch older Settlements therefore. A person can become a Settlor without realising it, e.g. by paying the legal fees of his parents' Grandchildren's Settlement!

Settlor's objectives

As professional advisers, we always seek to understand our Settlor Clients' objectives. Tax planning may be one of them, or it may not; but in all cases, the tax treatment of the proposed settlement must not conflict with their other intentions. The purposes for which people create Settlements include the following:

Family arrangements. People who want to give assets to young beneficiaries may not want them to be able to do what they like with the assets. An element of control is seen as necessary, at least until the recipients are old and wise enough to look after themselves.

Business succession. Where the asset to be gifted is a share in a business, or shares in a private company, retention of voting control by the giver may be essential, to help nurture the business before a full hand-over.

Disabled beneficiary. A discretionary trust can be useful where there is a need to provide for the long term care of a disabled person.




Charitable gifts. A new charity might be an individual's, or family's, way of putting benefit back into society, under their own control.

Tax planning. Trusts are often vehicles for obtaining special, beneficial, tax treatment for a family.

These notes are simplistic and by no means exhaustive. The areas covered are very complex, and traps abound. Advice must always be sought.

For more information or advice

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