

Don't let the kids blow it!


October 2007

There has been much talk recently of a new found enthusiasm for philanthropy among wealthy and affluent individuals, whether that involves giving a few hundred pounds to the local dog refuge or something more substantial to a private charitable foundation. It's all very well giving money to good causes but with a decent house in the UK now costing as much as the GDP of a small African country and university fees and associated costs likely to exceed the lifetime earnings of the average cleaner, for many people, charity is likely to begin at home.

Many successful individuals who have more than enough money for their own needs are keen to use their wealth first to make a positive difference to members of their family. The problem is that some beneficiaries might not be old enough to own assets or capital in their own name and the giver might be concerned that little Johnny, while a cute bundle of fun now, might grow up to be a little horror in terms of what he might wish to spend the money on when he legally gets his hands on the folding stuff at age 18.

....some beneficiaries might not be old enough to own assets or capital in their own name...

Until the 2006 budget Accumulation & Maintenance (A & M) trusts offered a very effective way of giving capital to younger generations of the family, without the underlying beneficiaries having an automatic right to the capital at age 18, or the capital in the trust forming part of their estate for inheritance tax purposes. Typically, income and capital would be advanced to fund school fees and help with other expenses, such as gap year trips. While the income and gains arising on the A & M trust were subject to 40% income and capital gains tax, if income was distributed to a non or basic rate taxpaying beneficiary, the beneficiary could reclaim all or some of the tax paid by the trustees. At least one beneficiary needed to have a right to trust income by the time they were 25.



Another useful feature was that the gift to an A & M trust was treated as a potentially exempt transfer for inheritance tax purposes. As such there was no immediate charge to inheritance tax at the time the gift was made and after seven years the gift was outside of the donor's estate. In the meantime growth arising on the A & M assets arose outside of the donor's estate.

Now new gifts to A & M settlements are treated in the same way as those to discretionary trusts and subject to an immediate charge of 20% if the gift, including gifts made to discretionary trusts within the previous seven years, exceed the nil rate band.

Individuals who wish to gift assets to minor children now have two main choices:

Gifting to a discretionary trust

A discretionary trust allows total flexibility as to who can benefit and the gift will fall out of the donor's estate after seven years. If the gift, when added to any previous gifts made to discretionary trusts in the previous seven years, is within the £300,000 nil rate band, then no immediate tax is payable. Otherwise any excess gift is subject to an immediate tax charge of currently 20%. A periodic charge will be applied every ten years at a maximum of 6%, but only to the extent that the value of the trust exceeds the then nil rate band. For this calculation the nil rate band is applied individually to each trust in existence.

Trustees of a discretionary trust are liable to income tax at the trustee rate of 40% in respect of savings income and 32.5% in respect of dividends. If the trustees wish to distribute income to beneficiaries of such trusts, they must account for 40% tax before making the distribution. This means that where income originated from dividends and tax at 32.5% was paid on receipt by the trustees, additional tax has to be paid. This adds a layer of complexity and additional tax for trustees who wish to distribute income which originated from UK dividends. On this basis, if it is known from outset that it is intended to distribute income to beneficiaries then discretionary trusts should preferably not be used.

Trustees of a discretionary trust pay capital gains tax (CGT) at the rate of 40% and have an annual exemption which is normally equal to only half of the exemption for individuals. The proposed changes to CGT would see trustees pay a flat 18% tax on gains arising. If a beneficiary of a post 21 March 2006 trust which is not a bare trust becomes absolutely entitled to trust capital it may be possible to "hold over" capital gains on assets distributed from the trust to the beneficiary.



Gifts to a bare trust

A bare trust is a means for an adult to hold assets for a minor until they become entitled to own the asset in their own right at age 18. For many people wishing to make significant gifts, the idea of a child automatically getting his or her hands on capital at 18, to spend on anything they want is not an appealing proposition. The added complication for parents making gifts to their children under age 18 via a bare trust is that all income arising from the gift in excess of £100 per tax year (£200 where parents are joint settlors) is taxed at the adult's highest marginal income tax rate. Capital gains are still assessed against the child beneficiary, who also benefits from their own capital gains tax allowance (£9,200 in the 2007/08 tax year).

An alternative approach

However there is a way of making a gift to a minor child which:

- is treated as a potentially exempt transfer and thus avoids an immediate tax charge;
- avoids the £100 income tax rule on parents who gift capital to their children via a bare trust;
- provides virtually tax free roll up of income and gains;
- provides access to some of the gift to fund education and other maintenance costs as required;
- does not allow the child access to the capital automatically at age 18 but instead at a later age specified by the person making the gift.

Enter the A & M plan

The basic concept is that the person making the gift invests in an offshore investment bond with multiple lives assured, ideally including the young person who the capital is intended for. This should avoid the bond becoming subject to tax on the gain on the death of the person making the gift.

The bond is then assigned to one or more people (this could include the person making the gift) who own the bond as bare trustee/s for the minor child. This is treated as a potentially exempt transfer and leaves the nil rate band untouched in lifetime. As long as the donor survives for at least 7 years, the gift will fall out of his/her estate.



The child will become absolutely entitled to the policy at age 18, as is the case with any gift to a bare trust. However, the bond has special policy provisions which are specified at outset and

...the bond has special policy provisions which have the effect of suppressing the surrender value of the bond....

which have the effect of suppressing the surrender value of the bond until a certain date of the donor's choosing. This could be when the recipient is, say, 25, or any other age which the person gifting the money thinks is appropriate. However, don't follow the lead of one of my clients who feels that 60 is the age when his children might be sufficiently responsible to benefit from the funds!

All income and gains arising in the bond roll up virtually tax free until what is known as a 'chargeable event' occurs. Such an event arises when either the bond is totally encashed; a withdrawal is made of more than 5% per annum (cumulative) of the original capital; or the death of all the lives assured on the bond. Currently gains are taxed at the owner's highest marginal rate i.e. up to 40% with no allowance for non-reclaimable withholding taxes. In certain cases it might be possible to time the chargeable event to arise when the beneficiary is either non UK resident or a lower rate tax payer. As the bond is technically comprised of lots of smaller segments it is possible to time encashments over a number of years to minimise or defer tax. This type of arrangement works best for higher rate tax paying parents who wish to make substantial gifts to minor children who have a fair chance of becoming non UK resident or a basic rate taxpayer when the policy acquires an encashment value. (Top slicing relief may prove useful too, as may time apportionment relief for any periods of ownership as non resident).

.....it is possible to time encashments over a number of years to minimise or defer tax.

In the intervening period between the date the policy is gifted and the date that the full value of the bond becomes available it is possible to specify that the policy can provide income to meet expenses such as education and other maintenance payments. As long as these are within the 5% annual allowance (with unused amounts from one year able to be carried forward to use in future years), then no immediate tax charge will arise.



So to summarise the options for making gifts.

A bare trust is preferable for people who:

- wish to make modest gifts;
- are happy for the child to have access to the cash at 18;
- require the investment strategy to be capital growth orientated and thus able to benefit from both the child's capital gains tax allowance and the new 18% flat rate on any excess gains;
- feel that the £100 rule on income will either be insignificant or doesn't apply as the donor isn't the parent.

A discretionary trust will probably be suitable for those who:

- haven't made gifts to a discretionary trust in the previous seven years which, when aggregated with the proposed gift, would exceed the nil rate band (currently £300,000);
- want a wide range of possible beneficiaries but also want to avoid any children having automatic access to capital at age 18;
- will adopt an investment strategy for the trust which avoids dividend income where income distributions to children are envisaged.

The A & M policy plan will be suitable for those who want to make significant gifts and who:

- want to avoid the capital passing to the child automatically at age 18;
- want the gift to be a potentially exempt transfer to avoid the 20% lifetime charge applicable to discretionary trusts because either the gift on its own, or when added to gifts made to discretionary trusts in the last seven years, exceeds the current £300,000 exemption;
- wish to pursue an investment strategy which balances capital growth and income with virtually no tax on an arising basis;
- as a parent wants to avoid the £100 income limit applicable to a bare trust or the additional tax which applies to dividends distributed under a discretionary trust;
- think that there is a good possibility that the recipient child will be either a non/basic rate tax payer or a non UK resident on encashment.



Bloomsbury Financial Planning

Your wealth in good health



There are only a few companies offering this type of contract but any half decent financial adviser or investment manager will know who they are.

George Best once said 'I spent a lot of money on booze, birds and fast cars. The rest I just squandered.' Let's hope your gift doesn't go the same way!

Contacts	Telephone	Email
Jason Butler	07973 951107	jasonbutler@bloomsburyfp.co.uk
Carolyn Gowen	07775 712969	carolyng@bloomsburyfp.co.uk
Robert Lockie	07951 725880	robertl@bloomsburyfp.co.uk

Disclaimer

This document is intended for informational purposes only and no action should be taken or refrained from being taken as a consequence of it without consulting a suitably qualified and regulated person. It does not constitute financial advice under the terms of the Financial Services and Markets Act 2000. Interested parties are advised to contact the entity with which they deal, or the entity that provided this document to them, if they desire further information. The information in this document has been obtained or derived from sources believed by Bloomsbury Financial Planning (BFP) to be reliable, but BFP does not represent that this information is accurate or complete. Any opinions or estimates contained in this document represent the judgement of BFP at this time, and are subject to change without notice.

© 2007 Bloomsbury Wealth Management LLP (which is **not** regulated or authorised by the Financial Services Authority)