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Case study:

Onshore Bond and gift trusts in practice.

Funding education

Overview: Gift Trust

Gift trusts are commonly used by individuals who want to provide for their children and/or grandchildren without giving them an outright entitlement to the assets. These trusts can be structured as either absolute "bare" or discretionary trusts. However, discretionary trusts are often preferred due to the additional benefits they offer.

Discretionary trusts provide greater control over when and how distributions are made. They also offer flexibility to add or change beneficiaries and protect the beneficiaries' estates from third-party claims, such as those that might arise in the event of a divorce.

When assets are transferred to a Discretionary Gift Trust, it is a chargeable lifetime transfer. However, there is no immediate charge to Inheritance Tax (IHT) as long as the value transferred is within the settlor's available nil rate band. Since the settlor is excluded from benefiting from the trust, the gift will be excluded from their estate for IHT purposes after seven years, thereby reducing their estate and IHT liability.

The trustees of a Discretionary Gift Trust have the authority to distribute benefits to any one or more of the individuals listed as potential beneficiaries.* Because none of the beneficiaries have an automatic right to benefit, the trustees can decide how much each beneficiary receives and when they receive it.

*There are two classes of beneficiary, potential and default, please see the guides and deeds for further information.

Case study Nicola and Marcello's tax-efficient provision for their daughter Elena

Background:

Nicola and Marcello are keen to make a tax-efficient provision for their daughter, Elena, who has just started at a reputable state secondary school. They have plans to send Elena to an independent sixth form college for her A levels.

Additionally, they are aware of the financial pressures she might face as a young adult and want to help her avoid accumulating too much debt during her university years. Like many parents, they also hope to assist her in getting onto the property ladder in the future.

Solution:

After discussing their situation with their adviser, they decide to invest a lump sum of £250,000 for Elena's benefit. To achieve their objectives, Nicola and Marcello decide to create a discretionary trust to hold the investment. This approach provides them with added flexibility and control.

Implementation:

They each make a Chargeable Lifetime Transfer (CLT) of £125,000, and the trust fund is invested in a bond.

After six years, the trustees make a discretionary decision to cover Elena's sixth form college fees for two years and use a £14,000pa withdrawal from the bond to fund the distribution. Since these withdrawals are within the cumulative 5% allowance, there are no immediate tax consequences for Nicola and Marcello, the settlors.

Once Elena completes her A levels, the trustees have the option to continue using the tax-deferred allowances or to assign cluster policies to Elena to help with her university expenses, depending on the amounts required.

Managing the trust over time:

Let's assume that when the bond reaches its first ten-year anniversary, it is worth £310,000. Under a discretionary trust, a "periodic charge" is due every ten years. Broadly speaking, the charge is 6% of the value of the trust property at the ten-year anniversary that exceeds the trust's available nil rate band. Although the amounts distributed to Elena within the preceding ten years will be taken into account when calculating the ten-year charge, the trust benefits from two nil rate bands because it was created by joint settlors. As a result, no Inheritance Tax (IHT) periodic charge arises, even when these previous distributions are taken into account.

In year 15, Elena wishes to buy a property. The trustees make a discretionary decision to assign the bond to her, without any tax consequences for her parents or the trustees. This allows her to encash the bond based on her own personal income tax position. Since she is a basic rate taxpayer and the bond is an Onshore Bond, Elena can fully surrender the bond, and may be able to utilise top-slicing relief, to reduce any additional income tax liability.

Summary:

By creating a discretionary trust, Nicola and Marcello are able to provide for Elena's education and future financial needs in a tax-efficient manner. The trust offers them flexibility and control over the distributions, ensuring that Elena receives the support she needs in a tax-efficient way.

The information in this leaflet is based on our understanding of current legislation and HM Revenue & Customs' practice. Both of these are likely to change in the future. Tax treatment will depend on personal circumstances.

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