

Education Trusts (Lecture P1299 – 20.42 minutes)

Introduction

Private education is expensive. School fees vary dramatically from school-to-school and area-to-area but seem to come in at around an average of £4,800 per term for a day school rising to £11,500 for boarding school. Multiply this by the number of children and eyes can begin to water.

And that just gets the children to either 16 or 18. I was fortunate enough to go to university at a time when both my degree and my liquid subsistence was paid for by the UK taxpayer (thank you all). Today's young adults are not so lucky and face fees of £9,250 year (plus living expenses). Student loans are all well and good, but the clue is in the title. Provided our newly educated offspring get a reasonably paid job, these loans are expected to be repaid.

Paying school fees from post-tax income is rarely the best solution. Instead structuring school-fee planning by using a trust can help soften the blow.

Trusts

Trusts offer a way of ring-fencing money for the benefit of our children and/or grandchildren without giving the beneficiaries unfettered and uncontrolled access to the funds.

The word "trust" can put some people off as the urban myth is that a) trusts are complicated, b) trusts are expensive both to set up and run and c) trusts are tax avoidance vehicles for the rich and infamous. All of these (unlike the creation of a child itself) are something of a misconception.

A trust is little more than a protected moneybox. The settlor puts money in, the Trustees look after it for a while and when either a) an event happens (such as a milestone birthday) or b) the Trustees decide it's the right time, the money is paid to (or used for the benefit of) those individuals who were chosen as the beneficiaries.

Most family trusts tend to invest in sensible assets such as listed shares, residential property and interest-bearing bank accounts, so the annual compliance and running costs are normally very manageable.

Trustees could charge for their time (and professional Trustees undoubtedly will), but this is not usually necessary as the Trustees tend to be members of the family who offer their time and experience free of charge. Yes, there is a cost in setting-up the trust as most will need a Trust Deed so the services of a solicitor will then need to be procured, but most Trust Deeds are standard documents (tailored for the specific requirements of the family) so costs should not be prohibitive.

The main decision to be made when looking to put some education planning in place is often therefore not whether a trust should be used but which type of trust is the most suitable.

Types of trust

Different types of trust give beneficiaries different rights at different times. Each is taxed slightly differently. Choosing the right one is therefore important.

The three menu choices are:

1. The discretionary trust;
2. The bare trust; &
3. The interest in possession (IIP) trust

There is no such thing as an “Education Trust”. Yes, you can set a trust and call it the “Smith Family Education Trust” if you want to (and if your name is Smith which it might not be), but this will be one of the above types of trust duly renamed with your family moniker.

Discretionary trusts

These are the most flexible (and therefore the most common) type of trust in use today as they offer the Trustees complete discretion as to how and when the trust fund should be distributed to the beneficiaries. This is the trust which the prudent settlor tends to favour.

Kids change as they develop. It may have seemed like a good idea at the time to set up a trust giving Johnny the right to the fund in its entirety on his 18th birthday, but as Johnny goes through his teens clearly struggling to develop into a mature human being, this can quickly start to become a bad idea. And once in place, this can be very difficult to vary.

Having the flexibility to defer any distributions until the beneficiary is mature enough to deal with the windfall is one of the prevailing reasons why discretionary trusts are the weapon of choice for many settlors.

Bare trusts

This is the simplest form of trust as the Trustees are no more than a “nominee” acting on behalf of the beneficiary. The trust fund (and any income generated by it) belongs to and is taxed on the beneficiary and the beneficiary can call for the fund to be appointed to him in its entirety as soon as his reaches his majority on his 18th birthday.

Bare trusts are suitable for beneficiaries with a “good head on their shoulders” or where the fund is relatively modest.

Interest in possession (IIP) trusts

IIP trusts sit somewhere in between. They offer the keys to the castle but not the castle itself.

An IIP trust gives the beneficiary (the “life tenant”) the right to the net income of the trust (after tax and expenses). This income cannot be accumulated by the Trustees (as it can in a discretionary settlement). This means that the beneficiary, however old he may be, will be legally entitled to a chunk of money each year and this cannot be held-back by the Trustees.

The life tenant’s right to income can be open-ended or time limited. Despite its title, a life tenancy does not necessarily mean a right to income for life.

The capital of the trust is typically reserved for a “remainderman” or “reversionary beneficiary” stipulated in the trust deed, although some IIP trusts do give the Trustees the right to pay capital to the life tenant at their discretion.

Transfers into trust

Once the vehicle of choice has been decided upon, the next step is to fund it.

Trusts can either be established by the settlement of a lump sum, or by regular (eg, yearly) contributions or by a combination thereof.

Since 2006, a gift to a trust is a chargeable transfer for IHT meaning that in the event that the transfer exceeds the available nil band (currently £325,000), an IHT “entry charge” must be paid. This charge will be at 25% as the tax itself will be paid out of the settlor’s funds which further increases the loss to his estate.

£325,000 is a sizeable sum and in many cases will be enough to cover expected education costs, so unless the settlor has a history of creating trusts, there is no reason why IHT needs to be paid on entry. Also bear in mind that in the case of a husband and wife settlement for the benefit of children or grandchildren, the nil band is effectively £650,000.

However, in the event that the trust needs to be funded at a level in excess of the IHT nil band, there are ways in which an entry charge can still be avoided:

- Create the nil band trust then resettle a further amount once seven years have elapsed. The initial settlement will fall off the clock after seven years and the nil band will be reinstated.
- Settle assets which are IHT relieviable. Shares in family trading companies are the obvious choice as transfers are normally IHT-free by virtue of 100% business property relief.
- Make regular gifts to the trust from income. Regular gifts by an individual from surplus net annual income are exempt for IHT. The recipient is irrelevant. Funding the trust with an initial settlement equal to the nil band then topping up by (say) regular monthly cash donations from after-tax income means that no IHT is payable (even if the settlor dies within seven years). There is no monetary limit to the “gifts from income” exemption so this gives scope for potentially large settlements to be made without an IHT charge.
- Use a bare trust for any excess funds. Gifts to a bare trust are treated as direct gifts to the beneficiary and are therefore PETs for IHT purposes (chargeable to IHT only if the donor dies within seven years). Creating a nil band discretionary trust then setting extra funds aside on a separate bare trust will avoid any lifetime IHT charges.

Where non-cash assets are to be settled, capital gains issues must be considered as the transfer to trust will be a disposal at market value by the settlor for CGT. Gains can be deferred where the transfer is chargeable to IHT (even where the transfer falls within the nil band or covered by BPR) unless the beneficiaries are minor unmarried children of the settlor.

In the case of a gift to a bare trust, as there is no immediate IHT charge, CGT deferral relief is only available for “business assets” (primarily shares in unlisted trading companies or furnished holiday lets). As a bare trust is not a “settlement” for CGT, unlike discretionary or IIP trusts, there is no denial of gift relief where the beneficiary is a minor child of the settlor.

Gifts of shares in family companies are particularly attractive as IHT protection is normally available in the form of BPR and CGT can normally be deferred. Even if gift relief is not available, gains might only be taxed at 10% anyway by virtue of Business Asset Disposal Relief on gains above the CGT exemption.

Remember that a lack of CGT deferral means that the assets are rebased to market value in the hands of the Trustees. So settlors could decide that paying CGT now at 10% is preferable to paying 20% later. [The tax paid also reduces the settlor's estate for IHT which is an added bonus.]

Taxation of trust income

This depends on the type of trust.

1) Discretionary trusts

Discretionary trusts pay income tax on most of their trust income at 45% (38.1% for dividends). This equates to the additional rate of tax for individuals and is therefore quite penal. The savings nil band and the dividend allowance are not available.

But don't let this put you off. Income distributions to beneficiaries are deemed to carry a repayable 45% tax credit. This is the case even if the trust income consists wholly or partly of dividend income on which tax was paid at 38.1%. If the beneficiary is a non-taxpayer (or pays only at the basic rate), the 45% tax credit will be wholly or partly repaid.

The Trustees must retain a "tax pool" to compare the tax paid by the Trustees with the tax credits which frank income distributions. Care should be taken to make sure this pool does not become overdrawn as the Trustees will then have to make up the difference. This is a live issue in the case of trusts funded by the settlement of shares in family companies where dividends are the main income source. Unwary Trustees would fund themselves with an unexpected income tax charge if distributions were too generous.

2) Bare trusts

The income of a bare trust belongs to the beneficiary and is therefore taxed at the beneficiary's marginal rate. The savings nil band and the dividend allowance are available. In many cases this will mean that the income tax liability will be nil.

Moving income-producing assets from a higher-rate taxpaying settlor into a bare trust for non-taxpayers will therefore leave more after-tax cash in the pot to meet school fees. This is far more efficient than the settlor simply paying these fees from his own post-tax income.

3) IIP trusts

IIP trusts pay income tax at the basic rate (20%) and dividend ordinary rate (7.5%). The net income then flows through to the life tenant as taxed income with an appropriate 20%/7.5% tax credit. If the beneficiary is not a higher rate taxpayer (highly probable for education trusts), some or all of these tax credits can be repaid.

In this sense, from an income tax perspective, using an IIP trust for school fee planning is no different to using a bare trust. However using an IIP trust gives the added degree of protection in that the capital of the fund does not automatically vest in the children at age 18. This will be a consideration if the purpose of the trust is to fund university / college fees.

In all cases, where the beneficiaries are non-taxpayers, all trusts offer the opportunity to be "income tax free" as the tax paid by the Trustees can (with careful planning) be recovered. However, income tax planning should always have regard to the parental settlements rules.

Parental settlements

Parental settlements are problematic for income tax. Where the beneficiary is a minor unmarried child of the settlor, any trust income which is applied to or for the benefit of the beneficiary is taxed in the hands of the parent. This prevents income distributions being made from the trust in order to utilise the (otherwise wasted?) personal allowances of the minor child. [There is a de minimis exception for income under £100 but this isn't particularly helpful.]

In the case of a bare trust or IIP trust, this means that income generated by parental settlements will be taxed on the parent settlor as it arises. For discretionary trusts, the income will only be taxed on the parent settlor if it is paid out.

This settlor attribution can be avoided by:

- Creating grandparental settlements. We know how much grandparents love their grandkids (it's the "common enemy" syndrome). Setting aside funds for the benefit of grandchildren ticks a lot of boxes, not least that it fits nicely as part of an overall IHT planning strategy for clients of advancing years. Where the settlor is not a parent of the beneficiary, trust income could be paid out to utilise beneficiary personal allowances. Any tax credits attaching to those distributions (representing income tax paid by the Trustees) would then be repaid. The distributed funds could then be used to pay school fees or sit in tax efficient investments (such as junior ISAs and other such products) until required.
- Waiting until the child is 18. Distributions from a parental settlement to a child aged 18 and over are not attributed to the parent. Many 18-year olds are still waiting to be gainfully employed and do not use their personal allowances. Therefore, in the case of a discretionary trust, income can be accumulated and paid out as soon as the beneficiary is no longer a minor. For this reason, parental discretionary trusts are perhaps not the most suitable for school fee planning and should be reserved to provide funds for university / college fees post age 18.
- Investing in assets which produce capital growth and offer no / low income yield. There is no settlor attribution of capital gains in UK trusts, so any gains made within a bare trust arrangement will always be taxed on the beneficiary (and utilise his annual exempt amount). Alternatively, investments could be chosen which "roll-up" income until the beneficiary's 18th birthday such as single premium insurance bonds or offshore roll-up funds. [A word with an IFA would be prudent if this route is to be followed.]
- Settling non-income producing assets such as "alphabet" shares in family companies where dividend payments can be deferred as required.

Other points to consider

Many taxpayers are put-off from using a formal trust due to the possibility of IHT "relevant property" charges when either capital is appointed or on each 10-year anniversary. Both discretionary and IIP trusts are subject to relevant property charges. Bare trusts are not. Instead, the assets in a bare trust form part of the beneficiary's own estate (which with child beneficiaries is rarely a problem).

However, in the case of a nil band trust, any capital distributions within the first ten years will not give rise to exit charges as the effective rate of tax is zero. Breaking the trust before the principal charge kicks-in is often sensible planning.

Conclusion

There is no “one size fits all” solution to school fee planning. However, the use of trusts – if properly structured and managed – can minimise income tax and reduce the estate of the donor at the same time.

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