

Using family trust for gifts of property

(Lecture P1138 – 11.57 minutes)

Consider a couple with a residential buy-2-let property portfolio who are looking for CGT and/or IHT mitigation strategies.

Placing some of their properties into a trust removes those assets from their estates while still allowing them to have a say in how the assets are used and, ultimately, who they pass to.

Using a trust as a vehicle to hold assets is particularly valuable in circumstances where the clients would like minor children to be able to benefit from the assets without giving them full control over the asset(s) gifted.

The simplest and most common type of trust is a discretionary trust under which the Trustees have full discretion over how the assets of the trust (and any income generated by those assets) are used.

The settlors will appoint the Trustees and nominate persons (or a group or persons) to be the beneficiaries. The Trustees will manage and control the Trust. The beneficiaries are the only persons allowed to benefit from it. Eventually when the Trustees see fit, the trust will be wound up and the assets will be distributed to the beneficiaries.

In a typical “grandparent” trust, the settlor would nominate his children to be Trustees and the children and their descendants to be the beneficiaries. This then gives scope for any additional grandchildren to automatically become beneficiaries of the trust as they are born.

The settlors can act as Trustees should they so wish. However, the settlors should be excluded from being able to benefit from the trust as this has negative tax implications.

If the settlor does not wish to be a Trustee, the settlor(s) can still influence the decisions of the Trustees by a non-binding Letter of Wishes which sets-out the settlors’ hopes and desires as to how the trust fund should be managed and allocated.

A trust is created by a Deed that needs to be drawn up by a solicitor. These are standard documents and are relatively inexpensive. The solicitor would also help draft a Letter of Wishes.

Inheritance Tax issues

A gift to a trust is immediately chargeable to IHT. However, IHT is only charged where the value of the transfer - being the value of the assets gifted – exceeds the IHT nil band. The IHT nil band is currently £325,000. For a trust with joint settlors, this means that up to £650,000 of value can be transferred to the trust without creating a liability. Such trusts are called “nil band” trusts.

A transfer in excess of the nil band will suffer an immediate IHT charge at 25% so it is advisable to restrict the value of the gifted assets to £650,000.

The creation of a nil band trust immediately removes £650,000 of value (£325,000 per person) from their respective estates.

If both clients' survive seven years from creating the trust, this saves £260,000 in IHT. If only one of them survives seven years, the IHT saving is £130,000. If both clients were to die within seven years, the position is IHT neutral - i.e. the value moves back into their estate as it is now.

If the trust is a route the client wants to pursue, it would be advisable for the arrangement to be put in place as soon as possible so as to start the seven-year clock.

There will be no effect for the tenants of the properties being transferred into trust as the trust would simply agree to take over the tenancy responsibilities.

The assets in the trust are not in the estate of any of the beneficiaries. Therefore, to prevent trust assets falling outside the IHT regime completely, trusts are subject to a tax charge on their value every 10 years (a "10-year charge").

This charge is 6% of the value of the trust assets in excess of the then nil band. For example, if the trust was formed by a transfer of properties with a combined value of £650,000, and those properties increased in value by 3% pa over 10 years, using the current nil band of £325,000, the 10-year charge would be in the region of £13,000. Many Trustees provide for this charge by retaining some income each year to meet the liability. If the annual capital growth was 3%, the tax liability is likely to be less than this as the nil rate band should increase in this timeframe.

This charge can be avoided by winding up the trust after 9 years and 11 months. Whether this is appropriate will depend on the situation of the beneficiaries at the point. Some of the grandchildren might be adults at that point and ready to accept a share of the fund outright at that point. This would reduce the 10-year charge. Alternatively, part of the fund could be appointed onto separate bare trusts for each beneficiary to then take outright at 18 (which again avoids a 10-year charge). These are options to be discussed with the Trustees nearer the time.

Capital Gains Tax issues

A transfer of an asset is a disposal for CGT purposes. The donor is treated as having sold the asset at its current market value and, in the absence of any reliefs, would pay CGT in the gain arising.

No CGT would be payable on a gift to trust as a claim can be made for the gains to be deferred.

The CGT deferral is the main reason why advisors recommend the use of a nil band trust as opposed to a direct gift of properties to children or grandchildren. No CGT deferral relief is available on direct gifts, so removing assets from the clients' estate by outright gift will come at a 28% CGT cost. The trust route avoids the 28% CGT.

It should be noted that gift relief is effectively deferring the CGT from the clients' hands into that of the next generation. If the properties are ever sold by the trust there will have a low base cost as a result of the gift relief claim. If the intention is for the properties to remain in the Trust in the long term then the CGT will not be realized for a very long time – if at all.

Stamp Duty Land Tax issues

SDLT is paid by the purchaser of an acquisition of property. However, where property is transferred at nil consideration – for example on a gift to trust – the SDLT is zero.

'Consideration' for SDLT includes the transfer of debt. Therefore, where a property is transferred to a trust and the Trustees assume responsibility for the mortgage attached to the property, the amount of the mortgage transferred is liable to SDLT. As the purchaser would be a trust, the additional 3% SDLT surcharge will apply.

Consequently, if a property (or properties) are to be transferred to a nil band trust as part of an IHT planning exercise, the properties should ideally be mortgage-free.

Income Tax issues

The income from the transferred properties would no longer be taxed in the settlor's hands. Instead the Trustees will pay income tax on their annual trust income. This is disclosed under self-assessment in the same way as for individuals.

The tax rates are 20% on the first £1,000 of annual income and 45% thereafter. This sounds expensive but in reality it is not.

Tax relief is available for the annual expenses of managing the trust (such as any Trustee expenses or accounting / tax return preparation fees).

If we assume a net 5% rental return, annual trust income would be around £32,500.

If we assume trust management expenses of £1,000 (which is reasonable for a nil band trust holding property), the income tax would be around £13,800 leaving net income of £17,700 available to either accumulate within the trust or pay to the beneficiaries.

Each grandchild could receive an income distribution of £1,650 (say). This would carry a 45% tax credit of £1,350, equating to gross income of £3,000 each.

As the gross income would be covered by the beneficiaries' personal allowances, the tax credit of £1,350 could then be reclaimed (giving a total annual tax refund of £12,150). Managed in this way, the actual income tax paid by the trust is very small.

Income distributions do not have to be made annually to achieve this result. For example, income could be retained in the trust and then distributed in (say) year 3. Each beneficiary would then receive £9,000 of gross income covered by personal allowances with the tax credits then repaid.

Similarly, beneficiaries do not have to receive the same amount (although care should be taken to ensure that gross income distributions fall within personal allowances to maximise the tax refund).

However, I would support the idea of annual distributions as this enables the parents to then divert these sums (and the subsequent tax repayments) into products such as Junior ISAs which can then build up tax-free for the grandchild to access at 18 (in time for going to college or university, or for help in acquiring a home).

Conclusion

The IHT effectiveness of the trust option relies on the clients surviving for another seven years. The younger clients start thinking about IHT planning the better!

And if they do survive seven years then they can do it all again!!