Old school or new school?

Inheritance tax and trusts Personal tax

01 April 2020

Tom Klouda and Daniel Andreca consider how to make the choice between a family trust and a family investment company

Key Points

What is the issue?

In passing wealth between generations, it is important for the appropriate vehicle (i.e. family trust or family investment company) to be implemented in order to ensure that the family's objectives around control, flexibility and tax efficiency are met.

What does it mean to me?

Advisers need to be able to guide on the implementation of a structure which facilitates the transfer of wealth between generations, while considering each family’s specific requirements.

What can I take away?

Choosing the appropriate vehicle to facilitate wealth succession can be a complex decision which depends upon many factors. Tailored advice and guidance should be sought.

Historically, trusts have been the ‘go to’ for passing wealth between generations as they provide a well-trodden and very flexible path for separating the legal and beneficial ownership of assets. However, the potential inheritance tax charges arising on the initial funding (as explained below), combined with more stringent reporti ng requirements and increasing professional fees of dealing with these requirements, have led families to consider using alternative structures to pass down wealth between generations.

One alternative model is the family investment company (FIC) which represents a bespoke vehicle, normally in the form of a private company whose shareholders are the various family members, and which would be used to hold and build the family’s investments. Although FICs will never be as flexible as a trust, due to their ability to build capital value in a tax efficient manner the popularity of FICs has significantly increased in recent times.

Initial funding

If an individual contributes funds into a trust, this will represent a chargeable lifeti me transfer for inheritance tax purposes. A 20% inheritance tax rate would be payable on the amount of funds which exceed an individual’s nil rate band available (£325,000 in respect of the 2019/ 20 tax year). In essence, this means that a couple can only tax-efficiently contribute assets up to a maximum of £650,000 into a trust every seven years, unless any of the relevant inheritance tax reliefs (such as business property relief) is available.

Conversely, funds can be invested into a FIC either via the provision of a loan or by subscribing for shares. Neither of these funding opti ons would normally be perceived as a transfer of value for inheritance tax purposes (subject to the ownership of the shares at the ti me); and therefore the potenti al 20% inheritance tax charge (as menti oned above) would not arise, regardless of the value of the funds contributed.

Distribution of funds

Depending upon the nature of any investment income received by the trust, income tax at the rates of up to 45% on non-savings and savings income and 38.1% on dividend income would be paid by the trustees before the net income can be distributed to the beneficiaries. Any distributions to benefi ciaries will carry a tax credit equal to the amounts of income tax paid by the trustees.
Alternatively, assuming that the FIC is a company tax resident in the UK, dividends received by the FIC would normally benefit from the dividend exemption, while other income would be subject to the more beneficial corporation tax rate (currently 19%). At this point, the directors and shareholders of the FIC have the flexibility to decide whether to distribute any income to the shareholders or to reinvest the net amount once any corporation tax due has been paid.

Should income need to be extracted from the FIC, the repayment of initial loan funding normally takes precedence before any additional income required is paid out as a dividend, in which case income tax at a rate of up to 38.1% would be payable by the shareholders on the dividend income, excluding the dividend allowance (£2,000 in the 2019/ 20 tax year).

Capital growth of investments

Any newly established trust is likely to qualify as a relevant property trust, meaning that inheritance tax charges would arise on each ten year anniversary based upon the value of the assets held, as well as each time an asset leaves the trust based upon the value of the asset transferred out.

The capital value of the assets, as well as any unextracted investment income (e.g. dividend), can be accumulated in the FIC without triggering a ‘ten year’ charge, making FICs a compelling alternative for the families who do not require a regular income stream.

Control and flexibility

Depending upon its nature, a trust could offer total flexibility of income and capital allocation between the beneficiaries. Subject to the provisions of the trust deed, when new family members are born, they can automatically form part of a class of beneficiaries.

FICs are more restrictive in the sense that shares in a FIC would need to be transferred or allott ed to new members. Once transferred, the shares in the FIC cannot practically be recalled. Some flexibility could be added to shares in a FIC by varying the rights attached to them. For example, with the use of diff erent share classes, parents could retain voti ng control with or without equivalent capital rights. On the other hand, their children may hold share classes with diff erent dividend entitlements, meaning that dividends can be paid in different amounts at different times. Children could also hold a 'hurdle' share class, entitling them to value above a certain threshold so they are incentivised to grow the family's wealth beyond the position at which they became shareholders in the FIC. However, when designing the rights attached to the various share classes, it is imperative for tax advice to be undertaken in order to avoid any unforeseen tax liabilities from arising. Transfers of value could trigger potential inheritance tax or capital gains tax liabilities.

Access to capital

Compared to a FIC, it may be off-putting to make a significant lifetime gift to a trust when the settlor cannot be sure they will not need access to their capital and the income it generates again. In addition, there are also significant anti-avoidance provisions prohibiting a settlor from accessing either the income generated and/or the capital assets once held by the trust.

From this perspective, a FIC can provide extra flexibility as it allows the initial founder to receive future income from the FIC either via a repayment of the original loan provided to the FIC and/or as dividend income, assuming that shares with dividend rights are retained by the founder.

Is there still a place for trusts?

Irrespective of the benefi ts of a FIC, there is definitely a place for the continued use of trusts. If the periodic charges are dealt with appropriately, a trust can help to mitigate many generations' worth of inheritance tax charges. A FIC protects a single generation (i.e. the parents) and their exposure to a 40% inheritance tax liability. This is because FIC shares will be IHT taxable assets in the hands of the shareholders, who tend to be the next generation. It is worth noting, though, recent publicity about investigations by HMRC on the use of FICs, especially to save inheritance tax.

FICs are not necessarily cheap to run and for relatively smaller amounts of wealth, the set up cost and ongoing maintenance is likely to outweigh the potential benefits, notwithstanding the added complexity and ongoing time required to manage them.

Conclusion

Despite the increasing use of FICs, ultimately there is no right or wrong answer and choosing between a family trust and a FIC will depend upon the priorities of the family, the amount of wealth to be passed and individual circumstances. In many cases, an appropriate solution might be to implement both a family trust and a FIC to blend the balance of control, flexibility and tax efficiency.

This article highlights some of the key tax matters that should be considered when choosing between a family trust and a FIC, and does not cover all the tax considerations that might be relevant. We strongly recommend that individuals considering a trust or a FIC for their family take advice tailored to their personal circumstances.