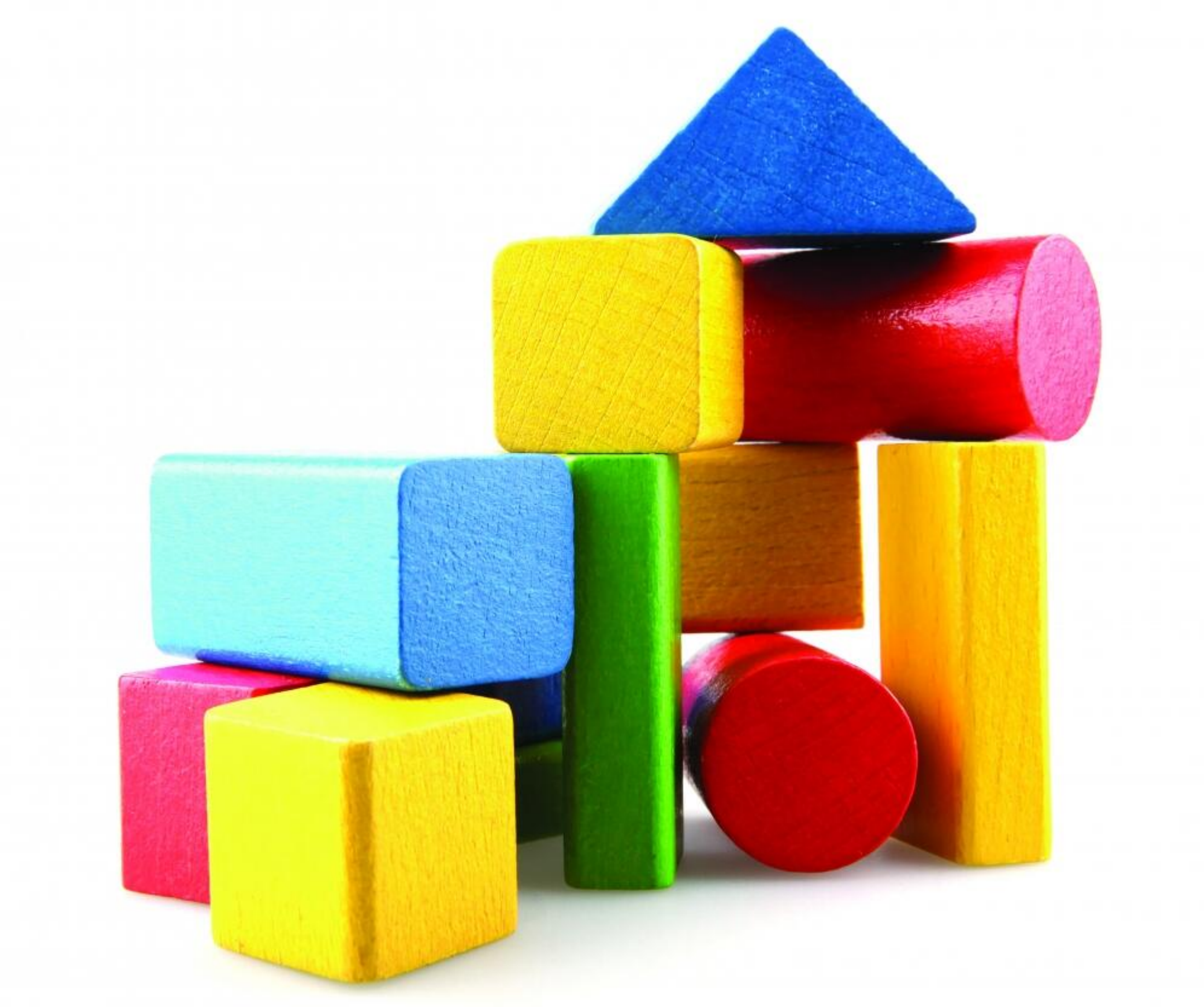
It isn’t child’s play…

Inheritance tax and trusts | Personal tax



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Chris Williams considers the complexities of settlements and tax planning to fund a child’s education

Key Points

What is the issue?

A study of the wide ranging anti-avoidance legislation applicable demonstrates why tax-efficient planning for a child’s education and support is difficult, especially for a parent.

What does it mean for me?

A parent who wants to create an arrangement that will be effective in providing for their own child’s education will find their options severely restricted, at least while the child concerned is a minor. However, there are ways in which a parent can make provision for their child’s future needs as an adult.

What can I take away?

Any trust for the education of a minor relative will be a chargeable lifetime transfer for inheritance tax purposes. The proportion of the settlement that falls outside the settlor’s available nil-rate band and is not covered by a relief or exemption will be immediately charged to inheritance tax at the lifetime 20% rate.

There are no special rules that apply to arrangements to fund education costs for family members – which is just as well really, when the general settlements legislation applies anyway. A study of the raft of anti-avoidance legislation applicable demonstrates why tax-efficient planning for a child’s education and support is difficult, especially for a parent. This is why the first part of this article is given over to considering what is not possible; once the impossibilities have been eliminated, we are left – to paraphrase a certain fictitious detective – with what is possible.

The options available will be affected by different tax treatments according to the ages and relationships of donors and beneficiaries. Donors may be parents, grandparents, other relations or friends. The recipients of their generosity may be pre-school, in school or in further education, though the main watershed is between minority and majority, i.e. their 18th birthday.

Settlements: the legislative background

A trust is a settlement but there does not need to be a trust for there to be a settlement. The Income Tax (Trading and Other Income) Act (ITTOIA) 2005 Part 5 Chapter 5 can be regarded as setting out the 'Settlements Code' and all statutory references in this article refer to ITTOIA 2005 unless otherwise stated. Section 619 is the charging section and the sections that follow describe more fully the scope of the charge and include restrictions of its scope which one needs to be aware of.

In s 620(1), the expression 'settlement' is primarily defined as any disposition, trust, covenant, agreement, arrangement or transfer of assets.

Settlor retains an interest

The first obstacle is where the settlor retains an interest in the settled property. A settlor is treated as having a reversionary interest in any settled property which is – or may in any circumstances, including the death of a beneficiary – become payable to or applicable for the benefit of the settlor or their spouse or civil partner (s 625(1)). This extends to circumstances in which the settled property may revert to the settlor by operation of law, including for example where a trust comes to an end because there are no remaining actual or potential beneficiaries.

Properly drafted trusts nowadays usually include longstop beneficiary provisions, whereby if there are no surviving beneficiaries the trust's property is required to pass to a named charity or the trustees must appoint a charity or other new beneficiary who is not the settlor or their spouse or civil partner. (For convenience, all references to marriage and spouses apply equally to civil partnerships and civil partners.)

Exceptions to the settlor interest rule

The settlor retained interest rule is strict but there are limited exceptions which are worth noting. The exceptions apply if, and only if, the settlor may become beneficially entitled to some or all of the settled property in any of the following circumstances:

- a person who is or may become beneficially entitled to the property or any related property is made bankrupt (s 625(2)(a));
- a person who is or may become beneficially entitled to the property or any related property assigns such property to the settlor (s 625(2)(b));

- settled property to which a person who is or may become beneficially entitled becomes subject to a charge; or, in Scotland, a right in security is granted over such property (s 625(2)(c));
- if the settlement is a marriage settlement, the deaths of both parties to the marriage and all or any children of the family (s 625(2)d));
- the death of a child of the settlor who had become beneficially entitled to the property on their 25th birthday or earlier; and
- it is not possible for settlement property or related property to become payable or applicable to or for the benefit of the settlor or their spouse during the life of another person, without activating the settlor interested charge, unless that person is made bankrupt or assigns or charges their interest in the property; and that person is under 25 years of age.

Trusts for the settlor’s minor children, including bare trusts

Nowhere in the above is there any reference to benefits received by a minor child of the settlor. This does not really get the would-be settlor very far because the trust will be liable at the trust income tax rate of 45%. That tax is available as a credit to the person who is taxable on receipt of income from the trust. However, when a minor child receives or becomes entitled to the income of a settlement made by their parent, it is not the child or their bare trustee who is liable for income tax; it is the parent, by virtue of s 629.

Note the reference to entitlement. In the case of a bare trust, the child is absolutely entitled to the income as it arises, regardless of whether the trustee pays or applies it to or for the benefit of the child (see HMRC Trusts and Estates Manual TSEM4300). Therefore, any income of the child in excess of £100 is taxable on the parent. The only crumb of comfort for a parent in this situation is that tax paid by the trustees is credited against the parent’s liability.

The same treatment applies if the child is given an interest in possession in trust property.

If the trust does not create an interest in possession, it is the trustees who are liable for income tax on income as it arises to them.

Possibilities for parents

A parent who wants to create an arrangement that will be effective in providing for their own child's education will find their options severely restricted, at least while the child concerned is a minor. However, there are ways in which a parent can make provision for their child's future needs.

Accumulation and capital growth

A parent looking ahead to future needs may create a trust without a current interest in possession which holds assets that will produce capital growth, rather than income (which would be taxed at 45%). This can enable money to be accumulated for release when needed, including after the child has reached majority. Settling a trust can also reap benefits in inheritance tax planning (see below).

Non-parents and planning for minors

The most restrictive provisions in Part 5 Chapter 5 apply only to the parents of minors. This leaves open a much wider range of options for grandparents, in particular, but also for other relations and friends of the family. I take grandparents as the examples here but other relations, including older siblings, can set up trusts for the benefit, including education, of their younger brothers and sisters.

The non-parental settlor must still be mindful of s 624 and the potential charge on a settlor who retains an interest. However, they should ensure that their trust deed allows for the exceptions in s 625 (set out above) to disapply the charge on the settlor.
Non-parents are also free to put assets into bare trusts for minors. In this case, the disposition is treated as an absolute gift to the minor, which is a potentially exempt transfer and so should fall completely out of account for inheritance tax purposes after seven years.

Lifetime settlements and inheritance tax

Any trust for the education or other benefit of a minor relative will be a chargeable lifetime transfer for inheritance tax purposes. This means that unless the settlement falls within the settlor's available nil-rate band or is covered by a relief or exemption, such as agricultural property relief or business property relief, the transfer will be immediately charged to inheritance tax at the lifetime 20% rate. It is also potentially re-assessable should the settlor die within seven years.

Grandparents considering an educational settlement should be mindful of the effect on their overall opportunities for inheritance tax planning. This is especially the case with settlements into trust, which should never be made before any outright gifts because of the interaction with other dispositions.

When a potentially exempt transfer becomes absolute, it has no further effect on subsequent chargeable transfers.

But if a chargeable lifetime transfer is followed by another settlement within the following seven years, the second settlement becomes chargeable: so the ‘tail’ on the first chargeable lifetime transfer in this instance can be up to 14 years.

Bare trust

The charge in s 629 is only a risk for the parent of the child for whom the bare trust is created. Therefore, any gift on bare trust for a person who is not a child of the donor will be effective.

Generation skipping

Another great advantage of a settlement by a grandparent is generation-skipping. Once property is in a well-constructed settlement, it will not benefit only the children whose education provided the original motivation. The trust property does not become the child’s parent’s property and so does not create for the parent the additional inheritance tax planning problem of increasing their estate. Property may remain in a trust, outside any individual’s estate, for up to 125 years.

When the parent of a child ‘inherits’ a trust created by their parent, any disposition of income in favour of their child will not be taxed on them because they are not the settlor.