WEALTH MANAGEMENT ALERT

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Playing the generation game to the benefit of all involved

Here are some ways clients may be able to help their families without necessarily giving up access to their capital or compromising their retirement income.

The power of the grey pound is often in the headlines, as affluent baby boomers enjoy spending their retirement income. The financial difficulties facing millennials, weighed down by debt and struggling to get on the housing ladder, are in the headlines equally frequently. We look at what clients can do to help bridge the gap in a way that meets the very different requirements of all generations.

Trusts still valid planning vehicles

Despite the various changes, trusts remain valuable vehicles for effective inheritance tax planning, offering various degrees of control over and access to the money placed in them.

But which type of trust?

As its name suggests, a flexible reversionary trust provides more flexibility than a discounted gift trust. It can give more control of control and, importantly, offers the ability to distribute benefits before the settlor's death. A discounted gift trust, on the other hand, allows the settlor to invest more than the nil rate band and to receive regular payments.

Sometimes both types can be used. For instance, a discounted gift trust can cover the settlor's known expenses and a flexible reversionary trust for their discretionary spending. If a client wants to reduce their likely IHT liability further, a gift and loan trust may be suitable, with loan repayments after seven years used to fund further gifting to discretionary trusts.

It is important to determine whether a client needs to retain access to all their capital and whether they wish to make regular gifts out of their income (which are free from inheritance tax (IHT), or a one-off gift.

Their decision may depend in part on whether they want to help their family now. For instance, a deposit for a house is likely to involve a one-off gift, while regular gifts from income could help with the cost of university, or they could be paid into a trust.

Flexible reversionary interest-in-possession trusts

Clients wanting to make a significant gift that reduces their inheritance tax liability, but who want the option of accessing the capital at a future date could make a one-off payment to a flexible reversionary interest-in-possession trust.

The payment falls outside the estate if the settlor survives seven years, and any growth falls outside the estate with immediate effect.

The settlor can retain access to a proportion of the fund each year. Any payments not required can be deferred to a future date. Capital or loans can be paid to the beneficiaries (for instance children, grandchildren or, indeed, the settlor at any time.

Clients with surplus income could consider paying it in to a flexible reversionary interest-in-possession trust. The payments and any investment growth fall outside the estate with immediate effect.

Loan to a flexible interest-in-possession trust

Clients who wish to reduce their IHT bill but can't afford, or are unwilling, to give up access to the capital, could consider making a loan to a flexible interest-in-possession trust.

The settlor makes an interest-free loan, repayable on demand. Investment growth is held for the benefit of the beneficiaries, while the loan (or any part of it not repaid) remains part of the settlor's estate for IHT purposes.

Regular repayments can be used to provide 'income' until the loan is fully repaid. As no gift has been made inheritance tax benefits only accrue on any growth. The trustees can make capital payments to the beneficiaries, subject to them being able to repay that proportion of the loan on demand.

Fixed reversionary interest-in-possession trust:

This may also suit clients only able to make a significant gift if they can continue to receive "income" from it.

The settlor gives up access to their capital in return for an "income" that is fixed at the start. If the settlor survives seven years, the gift is removed from their estate. If they don't, inheritance tax is calculated using a taper formula. Any growth within the trust falls outside their estate with immediate effect.

However, the trustees cannot distribute capital or make loans while the settlor is alive. Medical underwriting is required so

How a discounted gift trust helps John and Jenny cascade more of their wealth down the generations

John is a a serial software entrepreneur. Jenny, his wife, runs a successful yoga studio. They want their children, James and Helen, (not HMRC) to inherit their wealth when they are gone.

After talking things through with their independent financial adviser (IFA), they decide to invest £1 million in an international bond, the lives assured being those of their two children, assigned to a discretionary discounted gift trust, of which they are the trustees.

The trust is set up giving John and Jenny right to an annual payment of £50,000 for the rest of their lives. It is important that they spend the income to prevent it going back in to their estate for IHT purposes.

Based on their ages (both are 74) and following medical underwriting, the actual gift into the trust is valued at £463,520. The remainder is the estimated amount that will be paid out to them for the rest of their lives in regular payments.

They are underwritten individually. As both discounted values are less than the nil rate band and neither has made any other chargeable transfers in the last seven years, there is no IHT entry charge on the £1m they pay in to the trust.

Sadly, John dies suddenly five years later. The transfer is included in the IHT calculation for his estate. Only the discounted amount (which is below the nil rate band) falls into his estate, not the £500,000 he actually paid in. Jenny now receives John's payments as well as her own.

Jenny's IFA recommends that she appoint additional trustee, so she asks her brother and her solicitor to join her as trustees.

Unfortunately Jenny dies just over four years later. The international bond is valued at £996,000. As Jenny lived for more than seven years after making the transfer, there is no IHT to pay on the discounted gift trust.

The bond can remain in force because their children, who are the lives assured, are alive and well. The trustees decide to distribute the trust fund to them, but there are tax implications, depending on when they do so.

If they distribute the fund before its 10th anniversary, there will be no IHT exit charge, as there was no IHT charge when it was set up.

If they wait until after the 10th anniversary, a periodic charge will be payable. The periodic charge will be (£996,000 – (2 x nil rate band)) x 6%. An exit charge will also be payable.

If the trustees fully surrender the international bond in a tax year after that of Jenny's death, the trustees will have a chargeable gain to pay. The first £1,000 of this will be taxed at 20% and the remainder at 45%.

As James has now retired, and Helen hasn't been a UK resident for quite a few years, the trustees could assign half of the bond segments to each of them. This would not be a chargeable event.

When Helen cashes in her entitlement, the tax payable will depend on the tax laws of the jurisdiction in which she resides.

As a basic rate taxpayer, if James cashes in all his segments, assuming a chargeable gain of £248,000, he would lose his personal allowance and his personal savings allowance. However, top-slicing would be available and, based on nine years, this would amount to £27,555.

More tax-efficient options would be to take 5% tax-deferred withdrawals from his bond or to cash in segments from time to time. . Alternatively, if he doesn't need the money, he could assign segments to his wife or family as a gift. If he assigns segments to one or more family members, any amount falling outside available exemptions will be potentially exempt transfers from James.

that the value of the total income they are likely to receive can be estimated.

A flexible reversionary trust provides a greater level of flexibility than a discounted gift trust and can offer individuals a greater level of control – this can be attractive as can the ability to distribute benefits prior to the settlor's death. However, a discounted gift trust offers other advantages, for instance the ability to invest more than the nil rate band and for the settlor to receive regular payments.

The value of your investments can go down as well as up, so you could get back less than you invested. Tax advice which contains no investment element is not regulated by the Financial Conduct Authority. LighthouseCarrwood Limited is an appointed representative of Lighthouse Advisory Services Limited which is authorised and regulated by the Financial Conduct Authority.

We are experienced in helping people cascade more of their money down the generations, using legitimate IHT planning strategies. We would be happy to work with you to advise your clients about how they can do this in a way that suits their requirements and those of their beneficiaries. To refer clients to us or to discuss how we could work together, email Phil Mason, Business Development Director, LighthouseCarrwood Limited. phil.mason@lighthousegroup.plc.uk.

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