ARE YOU GETTING THE MOST OUT OF BARE TRUSTS?

Is it possible for parents or grandparents to make gifts to their children or grandchildren while avoiding adverse inheritance tax (IHT) consequences, producing tax-free income, remaining free of capital gains tax (CGT) and having absolute certainty that the chosen beneficiary(ies) will receive the benefits?

Yes it is. Through a combination of collective investments on the Advance by Embark Platform and the Advance Bare Trust, you can create a highly tax-effective and simple to administer investment strategy that meets all of these objectives.

For intermediary use only

Not for use with your clients

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BASIC PRINCIPLES

A bare trust enables an investor to:

- make an investment in collective investments
- hold the investments in a trust for the benefit of a named beneficiary(ies)
- keep an element of control over the investment by being a trustee whilst the named beneficiary is a minor.

There can be joint donors who could be parents or grandparents of the beneficiary(ies). The donor(s) will always be a trustee(s) and should appoint at least one additional trustee but preferably two.

The investments can only be used for the benefit of the named beneficiary or beneficiaries – donors can name more than one if they want. Once selected, this beneficiary (or their shares, if more than one) cannot be changed and so the donor must be happy with the choice of this beneficiary at outset.

The bare trust is normally used in connection with gifts for the benefit of children/grandchildren who are minors.

The beneficiary can, in theory, claim the trust property at age 18 although, with agreement of the beneficiary, this doesn't always happen in practice.

Tax advantages of bare trusts:

- The gift is a Potentially Exempt Transfer (PET) and as such, no immediate IHT charge will arise irrespective of the size of the gift. The donor needs to survive seven years for the gift to be exempt from their estate for IHT.
- Capital gains arising on encashment of the investment will be taxed on the beneficiary – irrespective of age and relationship to the donor. This means the beneficiary's annual CGT exemption of £12,300 for 2021/22 can be used to offset against any capital gains. This should mean that any model portfolio rebalancing that takes place should be tax-free and, managed properly, there should be no CGT on final encashment.
- Income arising on collective investments in the trust (including accumulated income) will normally be taxed on the beneficiary. However, if the beneficiary is a minor, unmarried child of the donor and income (on all gifts between that donor and child) exceeds £100 gross per donor in a tax year, it will all be taxed on the donor. This will not be the case if the donor is someone other than a parent.

THE CASE FOR ADVICE

Sally, aged 48, has a son George, aged 9. Following an inheritance from an auntie, she has some money she would like to use to establish a trust fund for George's benefit – perhaps to help him with the cost of a university education at age 18 or a later property purchase. Her mother (George's grandmother) Emma would also like to invest for George's benefit. She has £50,000 to invest.

Both Sally and Emma are entirely happy that:

- only George should be able to benefit
- George will, at 18, use the money in a responsible way – university or no university!

Sally invests £25,000 into a balanced portfolio of collective investments on Embark's Platform. Any income will be reinvested. She makes the investment subject to an Advance Bare Trust. She appoints Jason, her husband, as an additional trustee.

Emma establishes a separate trust for George investing £50,000 into a similar investment portfolio, and she appoints Harry, her husband, to act as trustee with her.

Taxation

Sally's trust:

- The transfer to the Bare Trust is a PET by Sally and so no immediate IHT is due. If Sally survives the gift by seven years, the gift is exempt from IHT.
- The mutual funds produce taxable income of 3%, which amounts to £750 in the first year and potentially more thereafter. Although this will be reinvested, because the donor is a parent and gross income of more than £100 a year arises, this will be taxed on Sally. This income may well fall within her annual dividend allowance of (currently) £2,000 and so not be taxable.
- Any capital gains arising on disposal of the collective investments (even through model portfolio re-balances and even though the trust was established by his mother) will be taxed on George. Therefore his annual CGT exemption of £12,300 for 2021/22 can be used to avoid or reduce any chargeable capital gains. This exemption will need to take account of any other capital gains attributed to George in the tax year e.g. capital gains arising under Emma's trust.

Emma's trust:

- All the tax implications are the same as for Sally's trust except that the income produced of around £1,500 in the first year and potentially more thereafter will be assessed on George (albeit reinvested). To the extent it falls within one of George's dividend allowance or, if used elsewhere, his personal allowance it will be tax-free.
- As stated above, George's annual CGT exemption will be available to be used against any realised capital gains under Emma's and Sally's trusts. With strong tax management this should enable a highly favourable and entirely or substantially CGT-free outcome for both trusts.

Planning at age 18

Assuming net growth (after charges) of 5% a year from reinvested income and capital growth, Sally's trust fund would be worth about £40,000 and Emma's about £80,000 when George is 18.

At that time, the trustees could gradually encash the collective investments to:

- provide George with a stream of tax-free capital that could meet the costs of higher education.
- keep capital gains on encashment within George's annual exemption and therefore effectively tax-free. In calculating capital gains, George would receive credit for reinvested income that has previously been subject to income tax. Of course, if a large encashment is made in a single year, say to release funds for a deposit for a property, then a CGT liability (at 10% on any gain – assuming gains keep George within the basic rate tax band at that point) may arise if the gain exceeds the annual exemption. However, this risk can be reduced through good investment and tax management throughout the investment period before realising any gains.

This case study is provided for professional adviser use only and strictly for general consideration only. No action must be taken or refrained from based on this case study alone. Accordingly no responsibility can be taken for any loss incurred as a result of any such action or inaction.

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FOR MORE INFORMATION ON THE ADVANCE BARE TRUST AND OUR OTHER TRUSTS, PLEASE SPEAK TO YOUR ADVANCE CONSULTANT.

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EMB-NP137377A06 (03/21) CMS