

CLIENT MEMORANDUM

TAX PLANNING WITH TRUSTS

Any client to whom the use of a trust is recommended for the first time could be forgiven for a sense of trepidation in the light of a whole range of new terms thrown at him or her.

The purpose of this Memorandum is, firstly, to set out in simple terms what a trust is and explain some of the terminology commonly employed in different types of trusts. Secondly, the Memorandum considers some of the benefits and possible disadvantages of a trust. Finally, examples are provided of how a particular trust might be utilised in different tax planning contexts.

What is a trust?

The most common characteristic of a trust is that it is a relationship in which one person, or persons, normally called a trustee, or trustees, is the legal owner of property held for the benefit of another person, or persons, normally called a beneficiary, or beneficiaries.

It is common to describe a trust as a settlement, and, vice versa. The person who creates a trust, and usually gives property to it, in the first instance, is known as a settlor.

It is preferable and good practice to bring a trust into existence using a written trust instrument. The document normally defines the initial trustee or trustees and sets out the rights and duties that the trust gives to them. The nature of these rights can be divided between 'trusts' and 'powers'.

A trust is a mandatory instruction, e.g. I give my shares in ABC Ltd to Fred and Lucy (trustees) to hold for the absolute benefit of Mary (beneficiary) subject to her attaining

the age of 21 years. Here, the trustees are obliged to give the property to Mary when she becomes 21

A power is discretionary, so the trustees may use their own judgement as to whether it should be exercised, depending on the circumstances of the beneficiaries. For example, most trusts contain a power of maintenance, enabling income to be paid to a young beneficiary for keep or the cost of education, even though the beneficiary, Mary in the example above, has no direct right to income until she is 21. There are usually many powers in a well drafted trust, divided between administrative powers, which give express authorisation to the trustees to undertake the management of the trust in a particular way, and dispositive powers.

Dispositive powers concern the benefits in the underlying trust capital and any income it generates. A power of appointment over income and capital enables the trustees to change the beneficial interests of beneficiaries in the light of future conditions. The most flexible form of trust is called a discretionary trust: in this variant, no beneficiary has a vested right in income or capital. The trustees may exercise their discretion in the form of a power to appoint income or capital to any one or more of the prospective beneficiaries. If they do not appoint income, it is typically accumulated, that is, saved for future use by the trustees.

As regards beneficiaries, if a beneficiary has the entitlement to receive income, he or she is described as having an interest in possession. This interest exists even though the trust is not actually generating income because, for example, it holds shares in a family company which is not currently making dividend distributions. Such a person can also be described as a life tenant.

Reversionary beneficiaries are those whose interest in the capital is subject to a prior life interest.

Benefits of a trust

Trusts have traditionally been used as a tool in succession planning to avoid death duties. Under the current inheritance tax ('IHT') régime, outright gifts (i.e. gifts which exclude the settlor and his or her spouse from benefit) usually constitute a potentially exempt transfer ('PET') which falls out of liability to IHT in respect of the donor's estate after seven years have elapsed.

A private trust is most typically employed in the present era to detach property or assets from a wealthy estate owner so that his or her estate is reduced with the consequence that the extent of inheritance tax on eventual death is reduced. The distinct benefits of employing a trust, as opposed to the direct transmission of property to beneficiaries, can be summarised, as follows:

- fiduciary control over assets and voting rights
- benefiting the younger generation without exposing assets to 'youthful folly'
- income tax benefits for adult children
- income tax benefits for infants where the settlor is not a parent and the money effectively belongs to the child (often referred to as a 'bare trust')
- some measure of protection from creditors and estranged spouses

Possible disadvantages of trusts

The key issue for a possible settlor who is concerned with inheritance tax mitigation is, can he or she afford it? Clients should be sure that they have sufficient assets and pension funding to sustain their lifestyle bearing in mind increasing life expectancy and the financial impact that low interest rates or continuing inflation may have.

Once clients are satisfied with this fundamental issue, trusts can be tax efficient in a number of ways although all trusts (except bare trusts – see below) are liable to the top rate of capital gains tax ('CGT') which is 40 per cent.

Examples of trusts

Different types of trusts are illustrated below by reference to the tax benefits usually associated with them.

It should be noted that the different trusts described below are not mutually exclusive. In other words, it is feasible and often desirable for one trust to be, in sequence, a discretionary trust, changed to an accumulation and maintenance trust, then an interest in possession trust and finally a 'bare trust' by reason of the trustees exercising a given power of appointment over income and capital.

Discretionary trusts

In this instance, the trustees hold the income and capital for a class of beneficiaries, where no one of them has a vested right to income or capital. It follows that none of them have an interest in possession in this type of trust.

So far as the settlor is concerned, a discretionary trust gives complete flexibility, which is very attractive. An important tax benefit is that no beneficiary is liable to capital taxation in respect of his or her own death.

If property not qualifying for any IHT reliefs is given to a discretionary trust, it is an immediately chargeable transfer and if the historical and present total of chargeable transfers made by the settlor exceed £285,000, IHT is chargeable at 20 per cent on the excess. There is a ten-yearly charge on capital within a discretionary trust, but the rate of tax does not exceed 6 per cent on these occasions. Finally, there is an 'exit charge' on property leaving a discretionary trust when paid to a beneficiary, or where the discretionary trust is terminated and the trust becomes a different type of trust.

Accumulation and maintenance trusts

These are discretionary or income accumulation trusts set up for infants and beneficiaries under the age of 25 years under which the beneficiaries will become entitled to an interest in the trust capital (either absolutely or as an interest in possession) at an age not exceeding 25. In the interim the income must be accumulated except for that applied for the education, maintenance and benefit of the beneficiary.

In the past, provided the trust satisfied the IHT exemption requirement, it enjoyed the benefit of exemption from the IHT charging régime for discretionary trusts described above. This meant that until a possible beneficiary acquired a vested interest, the trust capital was free of IHT except in relation to the PET exposure that existed for seven years after the settlor had made a gift to the trust. However, these trusts no longer have any other tax advantages and in fact are liable to the top rates of income tax and capital gains tax. Furthermore they are now radically affected by proposed changes contained in this year's Finance Bill as described later in this memorandum.

Interest in possession trusts

In the past a gift to an interest in possession trust was a PET for inheritance tax. So again, if the settlor survived any gift to the trust by seven years, there was no IHT by reference to his or her estate. However, such a trust is liable to IHT on the death of the person with an interest in possession. If there is a termination of that interest, e.g. by advancing capital to reversionary beneficiaries, there is a PET exposure on the trust for seven years after the termination.

With effect from 22 March 2006 there is to be a radical change in the tax treatment of new trusts of this type, as detailed further below.

The reason that clients use trusts such as these is to ensure that the benefit of their assets will go to predetermined beneficiaries. For example, a trust will often provide an interest in possession for the settlor's spouse, giving him or her an income interest throughout their lifetime. On the death of the life tenant, the capital will go equally to the settlor's children; perhaps employing an intervening accumulation and maintenance trust if a child is under the age of 25 at the death of the life tenant.

Bare trusts

This is the simplest form of trust, in which a trustee holds property absolutely for a beneficiary. Bare trusts are often employed to hold property for infants. However, any income that arises to an infant under 18 years of age is assessable to income tax on the parent, if he or she provided the capital of the trust.

For capital gains tax purposes, the acts of the trustee are regarded, in capital gains tax terms, as the act of the beneficiary. Where a 40 per cent taxpayer is contemplating a company sale, it is therefore useful to consider creating bare trusts for relatives and children so that each absolute beneficiary is entitled to the annual exemption of £8,800 and, beyond, the marginal rates of tax of 10 per cent and 20 per cent can be secured. Such transfers must be susceptible to hold over relief for capital gains as explained further below.

Recent changes to the taxation of trusts

The whole field of the taxation of trusts has undergone enormous changes in recent years and yet even more far reaching alterations are set out in the 2006 Finance Bill.

Two years ago all accumulating and discretionary trusts became liable to the top rates of income tax and also the top rate of capital gains tax (40 per cent). The net result of

these two changes was that nearly all the tax advantages of making trusts were swept away, and in fact it was quite possible for it to be disadvantageous to put money into trust. For example, the settlor's capital gains tax rate could never be more than 40 per cent, but in some years it might be less. Fixing the trust rate at 40 per cent means that the tax bill on gains realised on assets within a trust might well be greater than if the settlor had retained the assets in his or her estate.

One of the few remaining tax advantages in making a trust is therefore the removal of assets from the settlor's estate. So long as this is carried out more than seven years prior to the settlor's death, a saving in inheritance tax should be achieved.

Capital gains tax holdover relief

Two other important changes to the capital gains tax régime in relation to trusts were also introduced in 2004.

The first related to gifts to settlor-interested trusts. The gift of an asset into trust is a disposal at market value for capital gains tax purposes, but for gifts of business assets or gifts into a discretionary trust it is possible to make a claim for the trustees to take over the settlor's indexed base cost, thus deferring any tax charge until the trustees sell the asset. This is known as hold over relief. Previously hold over could be claimed even if the settlor was the principal beneficiary under the trust. However, following the Finance Act 2004, no hold over can be claimed if the settlor has any interest under the trust.

The other change to holdover relief concerned its interaction with private residence relief for capital gains tax purposes. If the base cost for a property is affected by a holdover claim, main residence relief will no longer be available for disposals of the property after 10 December 2003. Thus if a property is transferred to a trust, and the settlor makes a claim for holdover relief, on a subsequent disposal by the trustees of the property, main residence relief will not be available even if the property has been occupied by a beneficiary of the trust as his or her own residence.

Lower rate band

This year a reform has resulted in a reduction in the 40 per cent rate applicable to trusts for the first £1,000 of income arising to accumulating and discretionary trusts. This relief is available to all such trusts, and is not dependent on any election. The income within the £1,000 band is chargeable at either the basic rate, the lower rate or the ordinary dividend rate, depending on the nature of the income. Amounts of tax paid at the basic rate or the lower rate on this band of income then go into the trustees' tax pool. However, payments to beneficiaries continue to be certified net of 40 per cent tax so that the new £1,000 band will effectively be withdrawn if the trust income is fully distributed.

Yet more changes

All the reforms for the taxation of trusts in 2004 and 2005 have been eclipsed with sweeping changes announced in the 2006 Budget. These impact particularly in the field of inheritance tax.

As mentioned a transfer of funds to a discretionary trust was a transfer immediately liable to inheritance tax at 20% to the extent that the value of it exceeded the settlor's available nil rate band. Thereafter ten-yearly charges arise on the discretionary trust funds at a maximum rate of 6 per cent; very often the rate is less than this, as the calculations are by reference to a complex formula. There is then a proportionate charge if the trust is brought to an end between ten-year anniversaries, the rate payable being the same effective rate as on the previous ten-yearly event.

These rules did not apply to trusts where an individual had an interest in possession, nor did they apply to funds transferred into accumulation and maintenance trusts for infant children. Transfers into these trusts only became chargeable if the settlor died within seven years of making the settlement, but thereafter they had exempt transfer treatment.

The proposals in the 2006 Budget revoke the treatment of life interest and children's trusts and, in place, all lifetime settlements are to have the same inheritance tax treatment as discretionary trusts. This will operate as a major disincentive to setting up lifetime trusts, as it will mean that 20 per cent inheritance tax charges will arise on the making of virtually all lifetime settlements, unless the funds concerned are less than the settlor's available nil rate band.

Existing accumulation and maintenance trusts will only continue to benefit from IHT exemption if they are changed before 6 April 2008 to give beneficiaries absolute entitlement at the age of 18. After that date the inheritance tax 10-yearly charge régime mentioned above will apply either (a) immediately if beneficiaries may receive only an interest in possession on or before attaining the age of 25; or (b) if they will receive their share of capital between the ages of 18 and 25, that régime will commence as and when they attain the age of 18.

This proposed change does, however, have one beneficial side effect. This is that on the making of all lifetime settlements, it will be possible for the settlor to hold over any capital gain on the assets transferred in, so that the trustees can take them at his original base cost for capital gains tax purposes. Even so, this hold over is not available if the settlor or any of his infant children can have any possible benefit from the trust at any future time, and so the possibilities for holding over gains are strictly limited.

There are also changes proposed to the tax treatment of trusts set up by will. An initial life interest set up by the will continues to receive the existing inheritance tax treatment, so that no 10-yearly charges will apply and where the life tenant is the surviving spouse, the spouse exemption will also apply. However, on the termination of the life interest, the funds must vest absolutely in another beneficiary, or be held for children absolutely on attaining the age of 18.

Otherwise ten-yearly inheritance tax charges will thereafter arise, as with lifetime discretionary trusts.

With lifetime settlements, the new régime will be more favourable in certain cases. If the transfer into a trust is not chargeable to inheritance tax (as for example is the case

with a settlement of shares in an unquoted trading company), no inheritance tax will then be payable on the making of the settlement and thereafter only ten-yearly 6 per cent charges will arise if the trust has by then diversified into ordinary quoted investments. If the trust continues to hold shares in an unquoted trading company, business property relief at 100 per cent will apply after two years ownership. Previously with life interest trusts there was the possibility of a 40 per cent inheritance tax charge on the death of a life tenant.

FOR GENERAL INFORMATION ONLY

Please note that this Memorandum is not intended to give specific technical advice and should not be construed as doing so. It is designed to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topics.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.

CLIENT MEMORANDUM

IS YOUR COMPANY READY FOR SALE?

Clients involved in the day-to-day management of companies they own seldom have the time to plan for the time when they will sell their shares. But such planning can be critical both in terms of the price obtained for their shares and the tax ultimately payable.

The purpose of this Memorandum is to encourage our clients who hold shares in unquoted companies to consider at an early stage the steps which can and should be taken to ensure that when shares change hands their price is maximised and any consequent tax incidence minimised. There is no substitute for a well considered, well implemented exit strategy.

THE SHAREHOLDER

The earlier planning starts the better. Ideally shareholders should be considering tax and operational matters five years before a sale is anticipated.

As a general proposition, it is preferable to withdraw from the company surplus assets such as investments and excessive cash. There is often a case for withdrawing valuable trading premises from a company which then takes a lease back. The shareholder may feel that retention of the premises is a good investment for retirement. Such retention means there is no capital gains tax on this historical element of the company when the shares are sold. Finally, the diminution in asset value in the company will reduce the price of the shares to an extent and make the core business more affordable for the eventual buyers.

One of the reasons for planning five years in advance is that such radical restructuring of the company's Balance Sheet may distort the trading results in the short term. Corporation Tax may be payable on capital gains on disposals by the company, but this can often be offset by a trading loss, even if it arises from substantial pension contributions. The vendor wants to complete such radical reorganisation so that,

subsequently, his or her company can demonstrate two or three consistent years of improving profits which is the ideal prelude to achieving an optimum price.

Selling shares in an unquoted company will probably be the single most important transaction in a shareholder's life. It makes sense to ensure, as far as possible, that the fruits of the investment are enjoyed by the investor rather than the Inland Revenue.

Some of the possible tax planning matters to consider:

- Taking advantage of provisions to defer or avoid or reduce the payment of capital gains tax. These include taper relief and the Enterprise Investment Scheme. All require certain conditions to be fulfilled before full advantage can be taken of their benefits - careful planning allows the best utilisation of these reliefs.
- Ensuring that the shares held qualify as business assets to obtain the maximum level of taper relief. If shares did not qualify as business assets in the 17 March 1998 – 5 April 2000 period optimum taper relief may not accrue until 2010; tax planning steps may improve the position after two years.
- Transferring shares between spouses to enlarge shareholdings thereby maximising the benefit of re-basing on shares where value at 31 March 1982 is relevant. (This procedure also works in the case of a civil partnership).
- Establishing non-UK residence. Despite the 1998 Finance Act changes, it may still be possible to avoid capital gains tax by living outside of the UK while still making regular visits.
- Paying a pre-sale dividend.
- Shares in a trading company often qualify for 100% Business Property Relief from Inheritance Tax. When the company is sold, the cash proceeds will be liable to Inheritance Tax. For the vendor who wishes to make provision for his family, it is usually preferable to make gifts well before the sale of the company: the values of gifted shares are usually lower and surviving the seven year Potentially Exempt Transfer period is more likely.
- Review pension funding arrangements whilst there is flexibility before the shares are sold. Ensure that any actuarial surpluses that arise on premature death enure for the benefit of the vendor's family and not the purchaser of the company. There is often a case for converting from a conventional occupational pension scheme to a personal pension format.
- Establishing or enhancing the funding of a self-administered pension scheme, which will reduce Corporation Tax liabilities before the sale: loan backs and investments in the employer company can help cashflow.

- On 6 April 2006, the rules relating to privately funded pension schemes changed radically. It is important for directors and employees to review their position in the light of these changes. In addition, the Pensions Regulator now has considerable power to compel a company to make sure that its pension fund is adequately resourced. This issue needs careful consideration well in advance of a company sale, and it may be advisable to seek advance “clearance” from the Regulator.

THE COMPANY

The old adage “first impressions make the greatest impact” is never truer than when a potential purchaser reviews the financial history of a target company. What is he looking for?

First and foremost, a business with a proven track record and the potential to grow. Key indicators will be:

- sales and earnings growth
- stable gross profit margins
- positive cashflows, ideally capable of sustaining operations, funding capital investment and providing a return to shareholders
- efficient working capital utilisation
- a viable balance sheet

How can you ensure that your company is the one which catches his eye?

- maximise profits and cashflows in the run-up period to sale by:
 - managing trade debtors
 - eliminating slow moving or obsolete stock (tighten purchasing criteria and review base stock levels)
 - cancelling non-essential capital expenditure
 - considering carefully all research and development expenditure
- whilst it is always important for a company to ensure that its plant and computer equipment is viable and can sustain effective competition, it is usually better not to initiate major investment immediately, or in the two or three years, before sale
- isolate or sell under-performing or non-income producing assets - these may include loss making subsidiaries or parts of the business or vacant land and buildings
- a safe and easily achievable means of improving profit in the short term, before sale, is to eliminate unnecessary cost or overhead

A key question owner managers should ask themselves is: "How is my business performing compared to my competitors?" Answering this question may well point to areas in which improvements can be made.

Bear in mind that the acquirer is purchasing the promise of future cashflows and in this context it might well be appropriate to review whether or not directors' remuneration, including pension contributions, reflects commercial reality. Personal benefits for shareholders are best eliminated early so that profit is enhanced and the sale process is made easier. To give a better financial profile, distribution of profits by dividend may be the better alternative to funding lifestyles if a sale is envisaged.

Finally, the purchaser will require some indication of what the future holds. Clients contemplating the sale of a company are strongly advised to formalise their thoughts in this area, ideally in a formal plan covering the next two to three years, updated regularly for changing conditions. A well-reasoned vision of the company's immediate future can be a very valuable asset when negotiating its sale.

A WORD OF WARNING

At all costs owner managers should avoid the trap of allowing the process of selling the company to divert their attention from running the business. A customer or contract lost, production difficulties, or cashflow problems will probably reduce the price. Interesting as active involvement in the sales process may be, working shareholders may be best advised to employ specialists to guide them through the difficult days ahead, leaving them to concentrate on day to day management.

CONCLUSION

Planning the optimum exit strategy for individual shareholders is a complex and time consuming exercise. Many issues must be addressed including the inter-action of the various taxes (capital gains tax, inheritance tax and income tax) and, most importantly, the aspirations of the individual shareholders.

We will be pleased to discuss your individual circumstances with a view to planning an optimum exit strategy.

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