

James Hay Wrap

Trust and Tax Planning Guide

James Hay

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Introduction

This booklet is intended as a practical and technical guide for advisers who have clients using the James Hay Wrap platform. For these clients we offer a range of trusts which are detailed later in this booklet. The trusts have differing Inheritance Tax (IHT) consequences and it is important to fully understand these consequences. This booklet considers each trust separately and contains a number of worked examples.

On 5 December 2005 the Civil Partnership Act 2004 came into effect. From this date, same sex couples who enter a civil partnership will be treated the same as married couples for tax purposes. For the purposes of this guide therefore please note that a situation referring to a married couple will apply equally to civil partners.

The taxation information set out in this guide is based on our understanding of the general application of UK tax law and HM Revenue & Customs practice as at August 2009. The contents of this booklet, and any trust wording provided by us should not be used as the basis of advice given to individual clients without independent legal advice being sought. James Hay cannot be held responsible for any actions taken or refrained from being taken by individuals as a result of the information provided in this guide.

Section 1

Trust Fundamentals

What is a trust?

A trust is an arrangement which allows the ownership of an asset to be separated from its enjoyment. The person creating the trust, the settlor, transfers the legal ownership of the asset to the trustees who become the legal owners of the asset and who will hold the asset for the benefit of the beneficiaries. The trustees look after the assets of the trust in accordance with the instructions given to them by the settlor in the original trust document, the trust deed. The trustees are also guided by overriding legal principles and legislation.

Trustees – Appointment and Duties

Trustees must be at least 18 years of age, of sound mind and not bankrupt. Beyond that, as the name implies, trustees should principally be people whom the settlor feels can be trusted. All of our trusts automatically appoint the settlor(s) as a trustee. However, additional trustees could include family friends, family members, professional advisers or a trust corporation. Beneficiaries may also act as trustees although care should be exercised to avoid any conflicts of interest.

When accepting the role, it is important that the trustees fully understand the instructions given to them in the trust deed and the legal principles governing the trust. The Trustee Act 2000 came into force on 1 February 2001 for trusts established in England and Wales and updated the statutory powers and duties of trustees contained in the Trustee Act 1925 and the Trustee Investments Act 1961. Although the full provisions and implications of this Act are outside the scope of this guide, under this Act trustees have a new

statutory duty of care when carrying out their duties as well as a duty to act in the best interests of the beneficiaries. Similar legislation, the Trustee Act (Northern Ireland) 2001, came into operation in Northern Ireland on 29 July 2002. The part of The Charities and Trustees Investment (Scotland) Act 2005 relating to trustee powers came into force on 1 January 2006.

Beneficiaries – Bare or Discretionary

The Wrap Probate trust is only available as a bare trust for the person setting up the trust. Regarding the other trusts however, clients can choose whether they want to use the bare trust version or the discretionary trust version.

Beneficiary of a Bare Trust

Beneficiaries named on the trust form are absolutely entitled to the property held within the trust. This means they are the beneficial owners of the trust property and have a right to income or capital from the trust fund. The trustees of a bare trust cannot change the beneficiaries entitlement in any way. If the named beneficiary dies, the value of the trust property will be part of their estate and their will or laws of intestacy will determine who inherits the trust property. The trustees have no discretion over this.

If the beneficiary of a bare trust dies and that person is UK domiciled, the trust fund will be included in the beneficiary's estate for inheritance tax purposes (IHT). The value at the date of death would be added to their personal estate. It is therefore important to choose beneficiaries of bare trusts very carefully.

Please note that a Bare Trust is not a 'settlement' for IHT purposes. For this reason the word 'donor' will be used throughout the remainder of this guide in place of 'settlor'. For simplicity, we use the word 'donor' for a client who is setting up any of our Bare or Discretionary trusts.

Beneficiary of a Discretionary Trust

These beneficiaries only benefit at the trustees' discretion. No beneficiary has a right to income or capital. Instead, the trustees hold the trust fund on behalf of a range of beneficiaries including spouse, civil partner, children etc. The trustees' have complete discretion over who gets what from the trust. Accordingly, while the assets remain part of the trust, the value will not form part of any beneficiary's estate. This can be important not just for IHT purposes, but also for long term care purposes.

Discretionary trusts are however subject to the "Relevant Property Regime" which means that IHT charges may arise in three circumstances:

- On creation of the trust, an immediate "entry" charge at 20% of the excess value above the available nil rate band (£325,000 in the tax year 2009/10).
- A "periodic" charge of 6% on the excess value of the trust fund over the available nil rate band once every 10 years.
- An "exit" charge may arise on payments of capital between 10 year anniversaries.

Section 2

Why use a Trust in conjunction with an Offshore Bond?

What Investments Can Be Chosen in Conjunction with the James Hay Trust Range?

The James Hay Wrap Trusts have been designed to provide maximum flexibility over investment choice for clients and trustees. Historically, Inheritance Tax planning trust schemes offered by the financial services industry have tended to be used in conjunction with a single premium investment bond due to the fact that bonds are non income producing and therefore simplify the ongoing administration of the trust as well as offering certain tax advantages.

However since the reduction in the rate of capital gains tax from 6 April 2008 down to 18%, there is an argument for investing in collectives rather than bonds on the basis that any gains will be subject to tax at 18% compared with 40% on chargeable event gains on bonds. Gains on bonds are taxable at the settlor's income tax rate if they are alive and UK resident or if they have already died, gains are taxable on the trustees currently at 40% however this will increase to 50% from 6 April 2010. While the ultimate tax liability on bonds can still be minimised by the trustees assigning the bond to beneficiaries before encashment, the increase in the tax rate for trusts from next April appears to strengthen the argument for collectives rather than bonds.

However, using collectives with a trust can make the trust more complex to administer. Where an income producing asset is placed into a bare trust, any income

belongs to the beneficiary. So if the trust is one which allows the donor to have access to income, for example a Wrap Loan Trust or Wrap Estate Planning Trust, the trustees need to realise some of the capital to fund this which could have Capital Gains Tax (CGT) implications. Even where a discretionary trust is used, although the income does not belong to any of the beneficiaries, the trustees would need to do annual tax returns where income producing assets are held. So it seems likely that there will still be a continuing demand for bonds held in IHT planning trusts. There are various reasons why an individual might wish to place their bond into a trust but the most common reasons are listed below:

To avoid probate

Offshore Bonds are classed as overseas assets and therefore probate in that territory may be required when the owner dies. Grant of Probate/Letters of Administration (in Scotland referred to as Confirmation) refers to the situation where on a person's death the court must confirm that the executors are entitled to the deceased's estate before any assets can be distributed to the family. If a bond is placed into trust, it belongs to the trustees and neither UK nor offshore probate will be required on the donor's death providing there is at least one surviving trustee. Proceeds from the bond can therefore be paid to beneficiaries without any delay.

All our trusts are designed to avoid probate.

To control family assets

Many investors wish to set aside assets for the future benefit of members of their family whilst restricting beneficiary access until it is thought appropriate that funds can be distributed. If the bond is written in a discretionary trust, the trustees can be instructed to hold the bond until the beneficiaries, for example reach a certain age.

IHT planning for UK domiciled individuals

For individuals who are domiciled or deemed domiciled in the UK, IHT applies to their worldwide property (including offshore investments). If the total value of this estate, taking into account any transfers in the seven years prior to death, exceeds the IHT nil rate band (£325,000 for the tax year 2009/10) then tax will be due at the death rate of 40% on the excess. By arranging for the bond to be held under a suitable trust, all or part of the proceeds from the bond may be removed from the donor's estate for IHT purposes.

Section 3

Which Trusts are available?

1. **Wrap Probate Trust (Bare)**
2. **Wrap Gift Trust (Bare and Discretionary)**
3. **Wrap Loan Trust (Bare and Discretionary)**
4. **Wrap Estate Planning Trust (Bare and Discretionary)**

Common features of the Wrap trusts

- All avoid probate (assuming there is at least one surviving trustee at time of donor's death)
- Donor is automatically a trustee
- There should be a minimum of two trustees
- Trustees must be 18 years of age or over
- They are all subject to the laws of England and Wales or Scotland depending on where the donor is resident
- No POAT (Pre-owned Assets Tax) implications arise.

Our trust deeds are available free of charge, however, any documentation supplied is put forward for consideration only and clients are advised to discuss the terms of the trust with their legal advisers to ensure their objectives will be achieved.

1. Wrap Probate Trust (Bare)

Main points

- It is a bare trust for the person making the trust
- It can be established by single or joint individuals
- It can be used for new or existing bonds. It may also be used for other investments which the individuals wish to transfer into trust.

Benefits

- The sole purpose and benefit of this trust is to avoid probate. It simply facilitates the payment of proceeds or transfer of assets, after death, to the client's estate.

IHT implications

- It is a bare trust where the client remains the beneficial owner. Creating this trust is therefore IHT neutral.

2. Wrap Gift Trust (Bare or Discretionary)

Both trusts are designed for IHT planning purposes.

Main points applicable to both versions

- Can be established with single or joint donors
- Can be used for new or existing bonds. It may also be used for other investments which the Donor wishes to transfer into trust
- Represents the simplest form of IHT planning (Estate Reduction) in that the donor makes an outright gift.

Benefits applicable to both versions

- Designed to avoid probate
- Removes trust fund from Donor's estate on death for IHT purposes.

IHT implications

Bare Trust

- Establishment of the trust is a Potentially Exempt Transfer (PET) in favour of the "named beneficiaries". Provided the donor survives the gift by seven years the value of the gift will fall outside of his/her taxable estate.
- If the donor survives for between three and seven years, and has used up his/her IHT nil rate band, IHT will be due at reduced rates due to taper relief on the initial gift (less any available annual exemption) – see example
- If the donor dies within three years, then IHT will be due at the full death rate, again on the initial gift (less any available annual exemptions)
- Any growth on the initial gift will not be included in the donor's estate
- A UK domiciled spouse should not be a "named beneficiary", otherwise the creation of the trust would be an exempt inter-spouse transfer, which would not achieve the desired result of passing "taxable value" to a younger generation
- The value of the trust assets will be deemed to be part of the named beneficiaries estates for IHT purposes.

Discretionary Trust

- Establishment of the trust is a Chargeable Lifetime Transfer (CLT). If the value of the gift (less any available exemptions) plus the value of any CLTs made in the previous seven years by the donor exceeds the nil rate band, an IHT liability of 20% on the excess will arise.
- If the donor survives for between three and seven years and the gift was in excess of the available nil rate band, the IHT liability must be recalculated using the death rate of tax of 40% although taper relief will apply to reduce this. Any tax paid on creation of the trust can be deducted from the final tax liability.
- If the donor dies within three years, then IHT will be due at the full death rate as above however, no taper relief will apply
- Any growth on the initial investment will not be included in the donor's estate
- Although the donor's spouse is included as a discretionary beneficiary, extreme caution should be exercised if benefits are to be paid to the spouse during the donor's lifetime. If such amounts benefit the donor in any way, establishment of the trust would be deemed a gift with reservation by associated operations, and would be completely ineffective for IHT purposes.
- The trust property will be subject to the Relevant Property Regime as outlined on page 5.
- Lifetime transfers into such trusts need to be reported where they exceed certain limits. There are certain circumstances where an immediately chargeable transfer can qualify as an 'excepted transfer' and therefore does not need to be reported to HMRC:
 - (i) Where the value transferred is attributable to cash or quoted shares or securities, no reporting will be necessary where the cumulative total of all chargeable transfers made by the transferor in the 7 years before the transfer does not

exceed the Nil Rate Band. Assume a transferor makes his first transfer of £331,000 cash into a relevant property trust in August 2009. This will qualify as an excepted transfer since the chargeable transfer after deduction of annual exemptions is £325,000. If there are any other assets involved, the transfer cannot be excepted under this test.

- (ii) Where the value transferred is attributable to any other property, then two tests must be passed. Firstly, the value transferred plus the settlor's cumulative total in the last 7 years does not exceed 80% of the Nil Rate Band. Secondly, the value transferred must not exceed the Nil Rate Band available to the transferor. Assume a cash gift into a discretionary trust in August 2009 of £200,000 (no annual exemptions are available). This is an excepted transfer since the gift is attributable to cash and is below the Nil Rate Band. Later, in November 2009, an investment bond worth £50,000 is gifted into trust. This too is an excepted transfer because although this second disposal is not of cash, the cumulative total does not exceed 80% of the Nil Rate Band.

Where the transaction is concerned with an insurance linked product the question of whether or not the transfer is attributable to cash will depend on the circumstances of the transaction. It will be attributable to cash if the transferor pays an amount in cash/cheque/bank transfer and he needs to take no further action to complete the transfer (and cannot stop any further steps required to complete the transfer from taking place). This will usually be the case where the insurance product and related trust documentation are all completed at the same time and product placed in trust from the outset.

Where however the transferor purchases an insurance product which he then places in trust, this is clearly a transfer of an asset other than cash and the 80% limit would apply.

Where a discounted gift scheme is purchased, the value transferred is the amount computed after the discount has been taken into account. If it is subsequently discovered that too great a discount was claimed then an account should be delivered within 6 months of that discovery. Where an account is late, the normal late account penalties will apply.

The provisions apply to all transfers made on or after 6th April 2007.

Future planning opportunities

- Additional top-ups are allowed and are treated, in the case of the bare trust as subsequent PETS from the donor's estate and CLTs in the case of the discretionary trust.

Discretionary Trust Example

James is UK resident, has made no previous gifts and wishes to invest £350,000 in an offshore bond via the James Hay Wrap (tax year 2009/10). He has no intention of using this capital in future and requires no access to the investment. He ultimately wishes the investment to pass to his three children when he dies. All the children are over the age of 18, however he would like flexibility

to change the beneficiaries should the need arise. He can't decide whether to:

1. Place the bond into the Wrap Discretionary Gift Trust with his three children as intended beneficiaries but retaining trustee discretion.
- OR
2. Not use a trust and instead leave the investment to his children in his will.

Assume James dies 5 years and 2 days later when the bond is worth £450,000 and the rest of his estate is valued at £400,000. The IHT position can be compared as follows (the nil rate band in 2009/10 is used for the purposes of these examples):

Option 1: Create Discretionary Trust

CLT on the creation of the Discretionary Gift Trust:

Amount of initial investment into trust	£350,000
Less current year's IHT annual exemption	(£3,000)
Less prior year's IHT annual exemption	(£3,000)
	£344,000
Less IHT nil rate band	(£325,000)
Chargeable to IHT	£19,000
Lifetime Tax at 20%	£3,800

Taper relief of 60% available as James died between years 5 and 6.
So 40% of the death rate of 40% = 16%

16% of £19,000	£3,040
Less already paid	£3,800
No further tax due	<u>£0</u>

None of the earlier tax paid is recoverable

Tax on estate at death: value of estate	£400,000
Less IHT nil rate band (already used)	£0
Chargeable to IHT	£400,000
Tax at 40% on death estate	£160,000

The discretionary trust will be subject to the Relevant Property Regime and therefore may be subject to periodic charges every ten years and exit charges on any capital distributed from the trust.

For this example, assume the funds are distributed from the trust immediately after James' death. An exit charge will therefore apply as follows:

Value of property in trust at outset	£350,000
Add CLTs made by donor in the 7 years prior to creation	£0
	<u>£350,000</u>
IHT at lifetime rates on £350,000 (350,000 – 325,000) x 20% (notional tax)	<u>5,000</u>
Effective rate $\frac{5,000}{350,000} = 1.43\%$	
No. of completed quarters since creation of the trust	20
Applicable rate: 30% x 20/40 x 1.43%	0.00214
0.00326 x £350,000	<u>£749</u>
Exit charge	<u>£749</u>

Option 2: No trust used

IHT on estate at death when the bond was not written under trust:

Bond	£450,000
Balance of estate	<u>£400,000</u>
	£850,000
Less: nil rate band	<u>(£325,000)</u>
Chargeable to IHT	£525,000
Tax at 40%	£210,000
Total tax due on estate – no trust used	<u>£210,000</u>

Placing the bond under the trust has saved the estate a total of £50,000 on tax payable at date of death. The creation of the trust necessitated a small amount of lifetime tax and a small exit charge but they are more than compensated by the tax saved on the death estate.

Bare Trust Example

John is a UK resident, has made no previous gifts and wishes to invest £350,000 in an offshore bond. He has no intention of using this capital in future and requires no access to the investment. He wishes his three children to benefit and does not need any flexibility to

change this. He can't decide whether to:

1. Place the bond into a Bare Trust now and nominate his three children as named beneficiaries.

OR

2. Not use a trust and instead leave the investment to his children in his will.

Assume John dies 5 years and 2 days later when the bond is worth £450,000 and the rest of his estate is valued at £400,000 then. The IHT position can be compared as follows:

Option 1: Create Bare Trust

IHT arising on the failed PET:

Amount of initial investment into trust	£350,000
Less current year's IHT annual exemption	(£3,000)
Less prior year's IHT annual exemption	(£3,000)
	£344,000
Less IHT nil rate band	<u>(£325,000)</u>
Chargeable to IHT	<u>£19,000</u>

Taper relief of 60% available as James died between years 5 and 6.

So 40% of the death rate of 40% = 16%

16% of £19,000 **£3,040**

Tax on failed PET is primarily payable by the donees.

Tax on estate at death: value of estate	£400,000
Less IHT nil rate band (already used)	£0
Chargeable to IHT	£400,000
Tax at 40%	<u>£160,000</u>

Total tax due on estate & trust = £160,000 + £3,040 **£163,040**

Each beneficiary will have the value of their share of the trust as part of their estate for IHT purposes.

Option 2: No trust used

IHT on estate at death when the bond was not written under trust:

Bond	£450,000
Balance of estate	<u>£400,000</u>
	£850,000
Less: nil rate band	<u>(£325,000)</u>
Chargeable to IHT	£525,000
Tax at 40%	£210,000
Total tax due on estate – no trust used	<u>£210,000</u>

Placing the bond under the trust has saved a total of £46,960 in IHT.

3. Wrap Loan Trust (Bare or Discretionary)

Main points applicable to both versions

- Trust can only be established by a single lender
- Lender makes an interest free loan to the trustees who in turn invest the funds, typically into an offshore bond
- Trust cannot be used with an existing bond.

Benefits applicable to both versions

- Lender has access to the original capital and can take regular or ad-hoc repayments of his/her loan which, in the case of a bond, are income tax deferred so long as the amount does not exceed the cumulative 5% allowance (see page 21)
- When the lender dies, the outstanding loan forms part of his/her estate and therefore the trustees may need to recall the loan if requested by the executors of the estate
- Since the lender is not a beneficiary of the trust, any investment growth on the bond falls immediately outside the lender's taxable estate for IHT purposes.

IHT implications applicable to both versions

- Establishment of the trust is IHT neutral; at inception the capital loaned to the trustees is the lender's absolutely and therefore remains within his/her taxable estate
- If the lender has taken loan repayments then to the extent that he/she has spent the money received as

repayments on disposable items, his/her taxable estate will be reduced

- Any growth on the initial investment is outside of the lender's estate for IHT purposes
- If the bare trust version is chosen the value of the trust assets less the outstanding loan balance will form part of the named beneficiaries estates
- If the discretionary version is chosen the value of the trust assets less the outstanding loan balance will be subject to the Relevant Property Regime and potentially subject to periodic and exit charges.

Example

Gerald has made no previous gifts and wishes to invest £100,000 in an Offshore Bond. He calculates that he will require withdrawals of £5,000 per annum from the investment, and wishes his grandchildren, both current and future, to benefit from the investment on his death.

Gerald has two options, he can either:

1. Establish a discretionary Loan Trust with his grandchildren as the intended beneficiaries. He would lend the trust £100,000 which may be invested in an offshore bond. The trustees would withdraw £5,000 per annum, and pass this to Gerald as repayment of his loan.

OR

2. Not use a trust and instead withdraw £5,000 from the bond each year. The remaining investment would be left to his grandchildren in his will.

Assume Gerald dies ten years later when the bond is worth £100,000. His outstanding loan to the trustees is £50,000 and the balance of his estate is £508,000. The tax outcome of the two options can be compared as follows (using current nil rate band figures):

Option 1: Create Trust

Loan remaining in Gerald's estate	£50,000
Balance of estate	<u>£508,000</u>
Total estate for IHT purposes	£558,000
Less nil rate band	<u>(£325,000)</u>
Chargeable to IHT	<u>£233,000</u>
Tax due at 40%	<u>£93,200</u>

Option 2: No trust used

Value of bond at Gerald's death	£100,000
Balance of estate	<u>£508,000</u>
Total estate for IHT purposes	£608,000
Less nil rate band	<u>(£325,000)</u>
Chargeable to tax	<u>£283,000</u>
Tax due at 40%	<u>£113,200</u>

If Gerald had written his bond under a loan trust, IHT of £20,000 would be saved because the growth in the bond of £50,000 would have been outside of his estate for IHT purposes. Please note that there is no 10th anniversary charge on the trust given that the bond value of £100,000, less outstanding loan of £50,000, is within the trust's nil rate band.

4. Wrap Estate Planning Trust (Bare or Discretionary)

Main Points applicable to both versions

- The trust is a discounted gift trust
- May be established with single or joint donors
- Trust established prior to the trustees applying for a bond
- Trust may include other assets provided by the donor such as mutual funds.

Benefits

- Trust allows donors to make gifts from their estate thus reducing potential IHT liabilities but still retaining withdrawals of capital from the trust fund
- The value of the gift is considered smaller than the monetary amount invested and therefore discounted to reflect the fact that donors retain access to the trust fund by way of annual payments from a specified contingent interest
- The solution is 'trust' based as opposed to 'product' based which provides flexibility if the trustees should decide to change the underlying investments.

IHT Implications

Bare Trust Version

- If the bare trust version is chosen, the discounted gift constitutes a PET

- Provided the donor survives the gift by seven years, the whole value of the trust fund will be outside of his/her estate
- Any investment growth is outside the donor(s) estate for IHT purposes
- The value of the trust fund will form part of the estates of the named beneficiaries for IHT purposes in their respective shares.

Discretionary Trust Version

- If the discretionary trust version is chosen, the discounted gift constitutes a CLT
- If the value of the discounted gift exceeds the donor(s) available nil rate band after taking account of CLTs made in the previous seven years, a lifetime charge to IHT will arise at half of the rate on death. Currently this means a charge of 20% will arise on the excess.
- Provided the donor survives the gift by seven years, the whole value of the trust fund will be outside his/her estate
- For death within seven years, further tax may be payable on the discounted gift. The tax is recalculated on the original gift using the available nil rate at the time of death, allowing for any taper relief which may be due and a deduction can then be made for any tax paid at the time the gift was originally made.
- Any investment growth is outside the donor(s) estate for IHT purposes
- The value of the trust fund will not form part of any of the beneficiaries estate but instead will be subject to the Relevant Property Regime and consequently Periodic and Exit charges may apply

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- The value of the donor(s) retained right to 'income' does not form part of the trust fund for the purposes of calculating any periodic/exit charges payable. Accordingly, no exit charges will apply when the donor receives 'income'.
 - The value of the trust fund for the purposes of calculating any periodic charges will be the value of the bond at each tenth anniversary *less* the value of the donor's remaining right to 'income'. Strictly speaking these rights would need to be actuarially calculated every ten years and underwritten at that time. HMRC have however confirmed that it will be acceptable simply to add ten years to the donor's age at outset for this purpose, provided that the discounted gift trust was underwritten when the trust was established, and providing the trustees are not aware of any change in health.

EXAMPLE – comparison IHT calculations on the death of the donor

Mr. Ritchie is a UK resident and UK domiciled individual. He sets up both a Wrap Gift Trust and a Wrap Estate Planning Trust with his children as intended beneficiaries, each for £100,000 on the same day, and dies within three years. Let's look at the IHT liability in respect of each trust assuming that the client has no available nil rate band with which to offset the IHT liability.

Wrap Gift Trust	Wrap Estate Planning Trust
<p>IHT is 40% of the initial value of the gift so the tax due is:</p> <p>£100,000 x 40% = £40,000</p>	<p>The discount would be calculated by estimating the open market value of the retained rights. This would depend on inter alia, his age, health and planned withdrawals. Assume that the actuarial value of the gift for IHT purposes is £38,900. This gives an immediate reduction in the value of the estate of £61,100 or 61.10%. The tax due would therefore be:</p> <p>£38,900 x 40% = 15,560</p> <p>Mr. Ritchie's IHT liability would therefore have reduced by £24,440*</p>

* This is assuming that the capital payments made to Mr. Ritchie are spent each year and are not allowed to accumulate within his estate, thus making them liable to IHT.

Section 4

UK Income Tax treatment of Offshore Bonds held under a Wrap Trust

How is an offshore bond taxed?

Offshore bonds are designed to accumulate income and gains within their funds. Consequently, the owners of such bonds do not have an ongoing liability to tax if benefits are not taken. Any gain on an offshore bond is subject to Chargeable Events legislation. (ITTOIA 2005 ss461 to 546) and what remains of the Taxes Act 1988 S539 to S552. A chargeable event arises:

- (i) In the case of a life assurance bond, on the death of the last life assured.
- (ii) In the case of a capital redemption bond, on the maturity of the bond.
- (iii) Upon the total surrender of the bond.
- (iv) Upon the assignment of the bond in exchange for money or money's worth.
- (v) Upon any excesses on partial surrenders arising in any bond year (i.e. taking more than 5% of the total investment paid into the bond each bond year).
- (vi) In the case of a personalised bond, a gain will arise on the final day of the bond year.

How is an offshore bond taxed when it is held under a Wrap trust?

Where a chargeable event arises on a bond under a Wrap discretionary trust and during the donor's lifetime, the donor will be liable to income tax on the chargeable gain. In the case of an offshore bond, there would be liability to starting, lower and higher rate tax. There is a provision under ITTOIA s538 whereby the donor may recover from the trust any tax paid pursuant to a chargeable event.

If a chargeable event occurs in a tax year after the donor's death or the donor is then non-UK resident, the income tax liability will fall on the trustees if they are UK resident. The rate applicable to trustees is 40% for the tax year 2009/2010. If the trustees are non-UK resident, then the income tax liability will be based on the tax position of a UK resident beneficiary receiving a benefit under the trust from the gain.

If the bond is held under a Wrap bare trust, where the beneficiary is an adult, that person will be taxable as the beneficial owner, absolutely entitled to the policy benefits. While the beneficiary is a child then the taxation position will be as above.

Opportunities for income tax planning

Gains arising on investment bonds held under Wrap trusts may be taxed on the donor, trustees or even the beneficiaries with varying tax effects depending on the circumstances. It is important to remember that bonds can be assigned out of trust to adult beneficiaries without creating an immediate tax charge and this will then transfer any tax liability to the recipients of the bonds.

Investment bonds are typically split into a number of mini bonds, known as segments or clusters. Each segment is a bond in its own right and is designed to increase flexibility.

Planning involves changing the legal ownership of segments to a person who will pay a lower rate of tax

on a chargeable event. This is achieved by assigning a whole bond or segments from one individual to another or from trustees to a beneficiary, by Deed of Assignment. Draft deeds are available on request.

For example if an adult beneficiary is to receive substantial partial encashments and the donor is in a higher tax bracket than the beneficiary, there is an advantage in assigning individual segments to the beneficiary, who then makes a personal encashment.

Where the donor cannot be assessed for tax, either because he or she is dead or is not a UK resident, the charge will fall on any UK resident trustees at a rate currently of 40%. If the beneficiary to whom a distribution is to be made is a basic rate tax payer (20% on investment bonds), then the trustees may assign the bond to that beneficiary prior to surrender in order that less income tax is paid on any gain. Bonds cannot be assigned to minors.

Please note that whether the trustees assign only segments or the entire bond to the beneficiary, then the relevant life office may not only require sight of the Deed of Assignment but also of the relevant client verification forms.

For example, a certified copy of a Passport or Driving Licence (bearing a photograph of the individual) or two other formal documents with appropriate reference numbers. Proof of the beneficiary's address may also be required, i.e. a utility bill dated within the last three months.

Prior notification is always advisable as there may be restrictions on assigning to beneficiaries who are resident in certain jurisdictions, for example the USA.

What is top slicing?

Top slicing, is the mechanism used to work out the effective rate of income tax payable on a gain. Where a bond has made a gain, it is divided by the total number of complete policy years the bond has been in force. This provides the 'slice'. If this 'slice' is then added to the individual's other taxable income and if it pushes him/her into being a higher rate tax payer, then the rate of tax will be somewhere between the lower rate of tax and the higher rate.

If the 'slice' is added to the individual's other taxable income and he/she remains a basic rate tax payer, then the whole of the gain, in the case of an offshore bond will be subject to income tax at the rate of 20%.

A non taxpayer can use his/her personal allowances and starting rate band if available. If it is an onshore bond then no further taxation will be due as the life fund will be deemed to have paid tax at 20%.

Needless to say, if an individual is already a higher rate tax payer, top slicing is irrelevant as higher rate tax would be payable on the whole gain.

Example

Based on tax rates for 2009/2010 of 10% on taxable savings income up to £2,440, 20% on the next £34,960 and 40% on the excess.

For example, the tax payable on a gain of £30,000 after 5 years would be as follows:

a) Assuming other taxable income exceeds the higher rate tax threshold, the full gain will be liable to 40% tax.

Gain	£30,000
Tax at 40%	£12,000

b) Assuming other taxable income amounts to £32,400.

Slice for higher rate tax –	
Divide gain by number of years	£ 6,000
Other income	<u>£32,400</u>
Total	£38,400
Less higher rate tax threshold	<u>£37,400</u>
Amount applied to higher rate tax	<u>£ 1,000</u>

There the amount applied to basic rate tax is:

	£6,000 – £1,000	=	£5,000
Tax on slice is	£5,000 @ 20%	=	£1,000
	£1,000 @ 40%	=	<u>£ 400</u>
Total tax on slice	<u>£1,400</u>		

Effective tax	<u>£1,400</u>	=	23.33%
rate on slice	£6,000 x 100		

Tax payable on total gain is			
23.33% of £30,000	=	£7,000	

Does top slicing still apply where a bond is held in trust?

Yes. Top slicing relief is available to a UK resident donor in the same way as it applies to individuals. Similarly if a bare trust is used, then an adult beneficiary can benefit from top slicing.

Top slicing cannot be used where UK resident trustees are taxable since they are automatically subject to 40% income tax (tax year 2009/10).

Top slicing relief is also available to a beneficiary where a bond or segments of an offshore bond have been assigned out of a trust to that person prior to surrender. In this scenario, the beneficiary is entitled to top slice the gain back to the commencement date of the bond (not to the date of the assignment).

If a bond has non-UK resident trustees and the trustees surrender the bond and pay the proceeds to UK resident beneficiaries, then those beneficiaries would be unable to benefit from top slicing relief.

What is time apportionment relief?

This relief applies where an offshore bond is held by an individual who is UK resident for only a part of the period between the bond's inception and a chargeable event. Where this happens, the chargeable gain is proportionately reduced (Income & Corporation Taxes Act 1988 s 553(3)) based on the number of days absent

from the UK divided by the number of days since the bond started. Please note however that where a bond is held in trust, the mechanism for reducing chargeable gains only applies where all the trustees are UK resident for the whole of the period between the bond's inception and the chargeable event (the Income Corporation Taxes Act 1988 s553(5)).

If there has been a loss, can I offset this figure against other bond gains or any other income?

You cannot offset the loss on a bond against a loss on another bond but you can offset it against other income which falls into the higher rate of tax bracket. This relief is called 'Corresponding Deficiency Relief'.

However, there is a limit on the amount of income subject to higher rate tax against which you can offset the loss of the offshore bond. This is determined by the amount of any previous chargeable gains. The amount used to offset against higher rate tax cannot be any more than the total amount of the previous chargeable gains. A chargeable gain is the amount in any given bond year which exceeds the accumulated 5%.

Consider a client who had invested £50,000. The bond runs for 5 complete bond years and he withdraws 5% every bond year with the exception of the 3rd bond year when he withdraws 10% of £50,000 = £5,000. £2,500 of this is within his cumulative 5% but £2,500 would be a chargeable gain.

Therefore, upon total surrender – if the client's surrender calculation had produced a loss of £6,500 and he had £5,000 worth of income which would be subject to higher rate tax – then he is entitled to a deduction to his tax liability but the deduction is only given at the higher rate. The deduction on his tax payable would be £500 (£2,500 x 20%) because the amount which can be deducted must not exceed the previous chargeable gains made on the bond.

This relief only applies if individuals (not trustees) are liable and since 3 March 2003 the relief is only given if the previous chargeable gain was deemed to be the income of the individual claiming the relief.

For further information please refer to the HMRC Helpsheet 'IR321' entitled 'Gains on Foreign Life Insurance Policies' (www.hmrc.gov.uk/helpsheets/ir321.pdf)

Technical Support

Our Technical Support Unit in Glasgow can help with taxation and trust queries. They are contactable through your James Hay Relationship Manager.

How to Contact Us

Call Wrap Enquiries on:

0845 606 5500

Lines are open 9am to 5pm Monday to Friday. To help us improve our service we may record or monitor calls.

Visit our website:

www.jameshay.co.uk

Email us:

enquiries@jameshaywrap.co.uk

Write to us at:

**James Hay
Dunn's House
St Paul's Road
Salisbury
SP2 7BF**

Please note that every care has been taken to ensure that the information provided in this guide is correct and in accordance with our understanding of current law and HM Revenue & Customs practice. You should note however, that James Hay cannot take upon itself the role of an individual taxation adviser and independent confirmation should be obtained before acting or refraining from acting upon the information given. The law and Inland Revenue practice are subject to change.

This brochure has been approved by James Hay Wrap Managers, an authorised person under the UK Financial Services and Markets Act 2000.

