

Should you choose a new trust or top up?



Key takeaways:



- Learn about the pros and cons of topping up an existing trust
- Know when it's more prudent to set up a new trust
- Learn how potentially exempt transfers (PETs) affect decision-making

Category:

Estate and trust planning

This case study considers a client who wants to plan for inheritance tax (IHT) planning, and examines what the options are.

Background

Priya Khan is a motivational speaker who is keen to start IHT planning. She wishes to gift some money into a discretionary trust. She advises you that she has made previous gifts into a discretionary trust. Priya wants to know whether she should top up the existing trust she set up some years ago, or set up a new trust for the new gift.

What should she do?

Let's assume that:

- ▶ Priya made the original gift five years ago, when the trustees invested the funds into an investment bond.
- ▶ Priya tops up the existing trust this year and the trustees use these funds to increment the existing investment bond.

What happens when the investment bond is eventually surrendered?

Top-slice relief:

- ▶ If the trustees surrender the bond while Priya is still alive and UK resident, any chargeable gain will be assessed against Priya (Priya has a statutory right to reclaim the tax under the terms of the trust from the trustees)
- ▶ If the trustees assign the bond to the beneficiaries who then surrender it, the chargeable gains will be assessed against the beneficiaries.

In either event, Priya or her beneficiaries would be able to apply top-slicing relief, which could reduce their ultimate liability to tax.

(Please note - if the trustees surrendered the bond in a tax year after Priya's death or her becoming non-UK resident, the tax liability would rest with them, and they would be unable to benefit from top-slicing relief.

On full surrender of the bond, Priya (or her beneficiaries) would be able to top-slice the gain by the number of complete years since the bond was taken out. This is despite the fact that the bond was incremented five years after the bond was originally taken out. Topping up the existing bond rather than establishing a new bond may reduce the ultimate tax liability upon surrender, as the top-slice divisor on the gains would be higher.

The argument for topping up the existing trust

Comparison 1: Two different investment bonds

Bond 1 - £200k invested into an investment bond March 2015

Bond 2 - £100k invested into a separate bond in March 2020

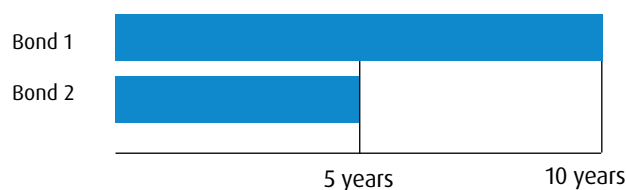
Both bonds are surrendered in March 2025 (after 5 and 10 years, respectively)

Bond 1 - Value after 10 years = £360,000*

Bond 2 - Value after 5 years = £134,000*

Top slicing	
Bond 1 = £160,000 / 10	£16,000
Bond 2 = £34,000 / 5	£6,800
Total top slice	£22,800

* assumes 6% pa growth



Comparison 2: Investment bond 1

£200k invested into an investment bond March 2015

£100k increment to bond in March 2020

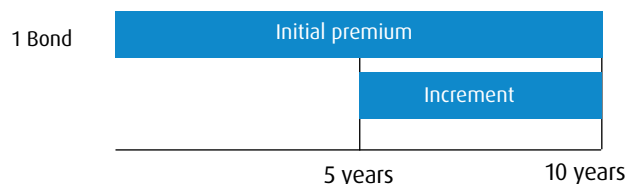
The bond is surrendered in March 2025

Bond value after 10 years = £494,000*

Top slicing	
Bond 1 = £194,000 / 10	£19,400

This is lower than in the previous example (£22,800)

* assumes 6% pa growth



But there are other issues to consider. These include:

- The 10-year periodic review
- The nil rate band
- The order of gifts

When the settlor establishes two separate trusts, there will be separate periodic reviews. Where an existing trust has been "topped up", there will be only one periodic review on each 10-year anniversary of the trust being set up.

Example

- Priya settles £200,000 into a trust in March 2015
- She adds an additional £100,000 in March 2020

The first periodic review takes place in March 2025, and the second in 2035. There is no periodic review in 2030, 2040, etc. It may seem simpler to have only one periodic review in respect of one trust, however, where additions have been made to the trust, it could be significantly more complicated.

S66 relief – IHTA 1984 s66(2)

At the 10-year periodic review, there is a relief available in respect of tax due on additions that were made to the trust in the previous 10-year period.

In the example above, at the first periodic review in 2025, there would be relief against the tax due on the value of the trust relating to the £100,000 addition made by Priya in 2020.

Example

In 2025, the first periodic review takes place

Top slicing	
The £200,000 settled in 2015 now valued at	£360,000
The £100,000 settled in 2020 now valued at	£134,000*
Trust value	£494,000

For the purposes of the periodic review the trust value is **£494,000**

But, £134,000 of that value relates to the £100,000 top-up which has only been in trust for 5 of the previous 10 years.

*assumes 6%pa growth

£134,000 of the value of the trust benefits from relief under IHTA 1984 s.66(2).

This suggests a tax saving, but this may not, in fact, be the case! Regardless of the actual tax, this is an additional administrative issue for the trustees to consider. This can become complicated if there have been multiple additions made at different times.

Each trust has its own nil rate band (NRB), and possibly multiple NRBs, if there are multiple settlors. Topping up an existing trust with an additional settlement DOES NOT create an additional NRB for the trust.

But setting up a new trust for the additional settlement does create a new NRB, although you would need to take account of all chargeable transfers made by the settlor in the seven years prior to creating the trust. This can have advantages at the 10-year periodic review.

Let's compare an addition to a single trust with separate trusts

Single trust

- £200,000 settled March 2015
- £100,000 settled March 2020
- Periodic review in March 2025

Assume NRB in March 2025	£359,000*
£200,000 valued March 2025	£360,000
£100,000 valued March 2025	£134,000
Total value at periodic review	£494,000

*£325,000 X CPI @ 2.5% from April 2021

Periodic review

£494,000 - £359,000	£135,000
£135,000 X 20% (lifetime rate)	£27,000
£27,000/£494,000 X 100	5.4656% effective rate
5.4656% X 30%	1.6397% settlement rate
£494,000 X 1.6397%	£8,100 tax

However, £134,000 of the trust value relates to an addition to the trust in March 2020 which has been in the trust for five years. Therefore, if a 10-year period is divided into 40 quarters, the addition has **not been in the trust** for 20/40ths (five years).

S62 relief

1.6397 x (20/40)	0.8199%
£134,000 @ 0.8199%	£1,099 relief
£8,100 - £1,099	£7,001 tax due

Seperate trusts

- £200,000 settled March 2015 (Trust 1)
- £100,000 settled March 2020 (Trust 2)

Trust 1

- Periodic review in March 2025
- Trust 1 now valued at £360,000 which is more than the prevailing NRB. Therefore tax is due as follows:

Assume NRB in March 2025	£359,000
£360,000 - £359,000	£1,000
£1,000 @ 20% (lifetime rate)	£200
$\frac{£200}{£360,000} \times 100$	0.0556% effective rate
$0.0556\% \times 30\%$	0.0017% settlement rate
£360,000 X 0.0117%	£42 tax

Trust 2

- Periodic review in March 2030
- £100,000 valued now at £180,000 NRB, therefore no tax is due:

Assume NRB in March 2030	£406,000*
£180,000 + £200,000 cumulative total†	£380,000
£380,000 - £406,000	£0 tax

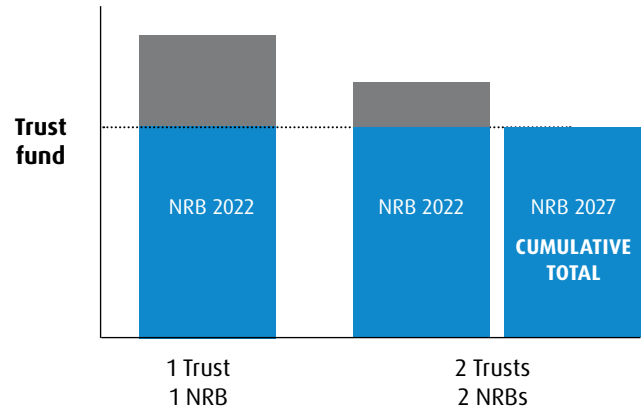
*£325,000 X CPI @ 2.5% from April 2021 (CPI assumed 2.5%)

† amount gifted to trust 1 – as within 7 years prior to Trust 2 being created

Total	£42 tax due
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So, despite no s66 tax relief being available, the combined tax in respect of the two separate trusts is less.

So, despite no tax relief available, combined tax in respect of the two separate trusts is less.



The settlors' previous cumulative total

Let's imagine that Priya made a potentially exempt transfer (PET) after making the initial Chargeable Lifetime Transfers (CLT) into the discretionary trust.

She made the PET after the CLT so that, in the event of her death within seven years, the failed PET would not form part of the seven-year cumulation of the trust at the 10-year periodic review.

- A PET made within seven years prior to the donor's death becomes a failed PET
- A failed PET is a chargeable transfer
- A chargeable transfer made within seven years prior to another CLT would be included in the periodic charge calculation of that CLT (discretionary trust) at the 10-year anniversary

Example

- Priya made a CLT into a discretionary trust of £200,000 in March 2015
- Priya then made a PET (gift to her son) of £200,000 in April 2020

Should Priya die within seven years of the April 2020 gift, the PET will fail but it will not affect the future 10-yearly periodic reviews of the discretionary trust. That's because the PET was made after the discretionary trust. However, Priya wants to put another £100,000 into a discretionary trust.

What happens if she makes an additional chargeable transfer into the existing discretionary trust? If Priya were to "top-up" the existing discretionary trust this would affect the way the cumulative total for the trust is calculated and could adversely affect future periodic tax charges.

If Priya dies within seven years of the April 2020 PET, the PET fails and becomes chargeable.

Because Priya "topped-up" the existing discretionary trust after making the (now failed) PET the failed PET now forms part of the seven-year cumulation for the discretionary trust.

An example

Priya makes the following transfers:

- £200,000 CLT in early March 2015 (value £360,000 in March 2025)
- £200,000 PET in April 2020
- £100,000 CLT in late March 2022 (value £120,000 in March 2025)

Priya dies March 2023, meaning the PET is now a chargeable transfer.

The trust periodic review is due in March 2025 (NRB assumed to be £359,000)

At this point the £200,000 fund originally invested in March 2015 is valued at £360,000 and the £100,000 fund originally invested in March 2022 is valued at £120,000*. Therefore the total trust value is £480,000.

(*£200,000 @ 6% x 10 years + £100,000 @ 6% X 3 years)

Periodic charge	
Trust value	£480,000
Cumulative total (failed PET)	£200,000
Total	£680,000
£680,000 - £359,000*	£321,000
£321,000 @ 20% (lifetime rate)	£64,200
£64,200/£480,000 x 100	13.3750% effective rate
13.3750 @ 30%	4.0125% settlement rate
£480,000 X 4.3375%	£19,260 tax

(*£325,000 X CPI @ 2.5% from April 2021)

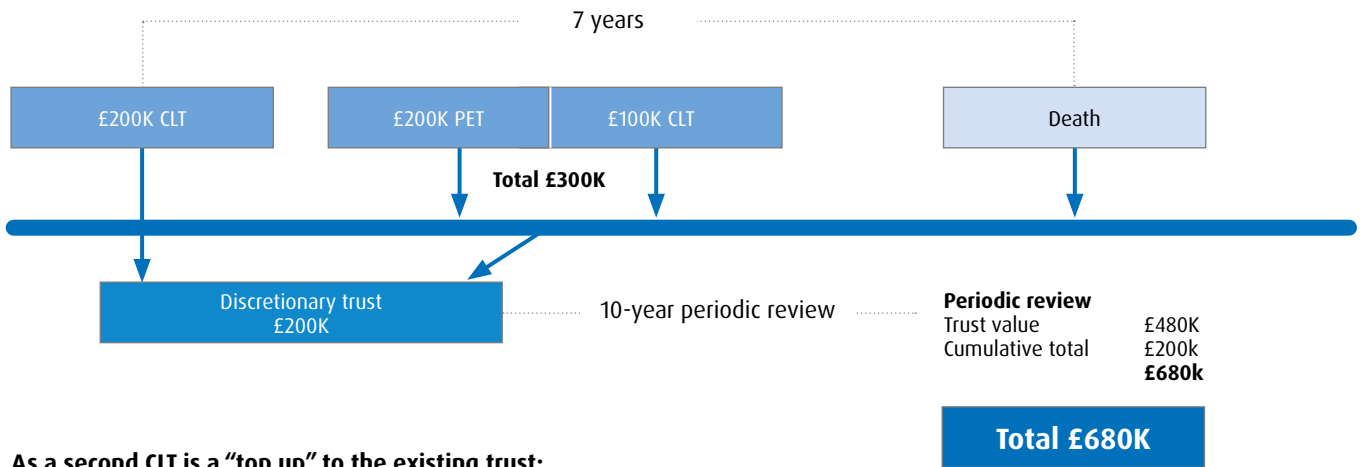
S66 relief

S66 relief applies in respect of the £120,000 of the trust fund as this relates to the £100,000 addition to the trust made seven years after the trust was originally created.

As seven years elapsed before the addition was made relief is available in respect of 28/40ths

4.0125 x (28/40)	2.8088%
£120,000 @ 2.8088%	£2,505 relief
£19,260 - £2,505	£16,755 tax due

An example (continued)



As a second CLT is a “top up” to the existing trust:

- ▶ PET is now part of the cumulative total
- ▶ One trust – therefore one Nil rate Band available

How would the situation differ if Priya had set up two separate trusts?

Trust 1 – £200,000 early March 2015
(value in March 2025 = £360,000)

PET – £200,000 April 2020

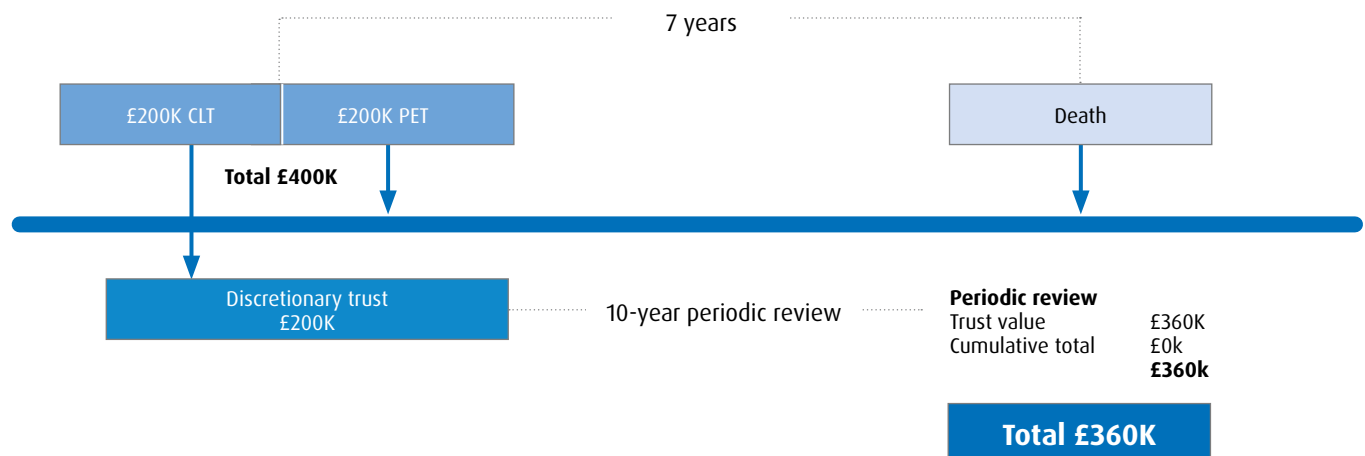
Trust 2 – £100,000 late March 2022
(value £180,000 in March 2032)

- ▶ Priya dies in March 2023, meaning the PET is now a chargeable transfer
- ▶ Periodic review for Trust 1 is March 2025 (NRB £359,000*)
- ▶ Periodic review for Trust 2 is March 2032 (NRB £426,000*)

(*£325,000 X CPI @ 2.5% from April 2021)

Trust 1

Trust value	£360,000
£360,000 - £359,000 NRB	£1,000
£1,000 @ 20% (lifetime rate)	£200
$\frac{£200}{£360,000} \times 100$	0.0556% effective rate
0.0556 @ 30%	0.0167% settlement rate
£360,000 @ 0.0167%	£60 tax

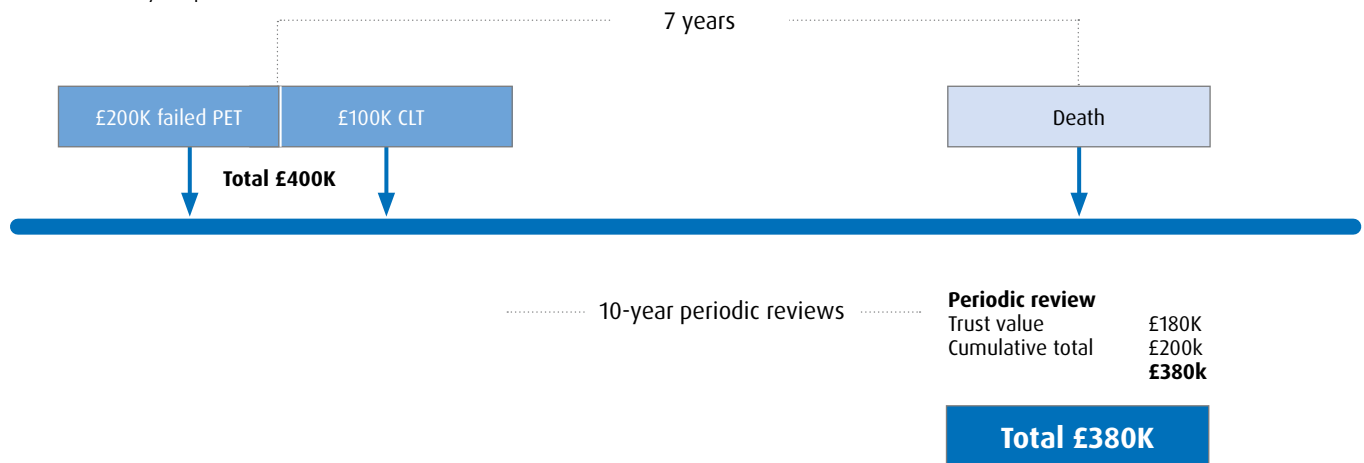


How would the situation differ if Priya had set up two separate trusts? (continued)

Trust 2

- £180,000 trust fund value + £200,000* cumulative total = £380,000
- £380,000 is less than prevailing NRB therefore no tax is due:
- £380,000 - £426,000 NRB = £0

*cumulative total includes the failed PET but not the £200,000 settled into Trust 1 as this was created more than seven years prior to the creation of Trust 2.



Summary

It may be more suitable for small trusts to be topped up where the risk of a tax charge at periodic review is slight and the benefits of having additional NRBs is negligible.

In these situations, the benefits of the top-slicing rules may outweigh the benefits of multiple trusts and multiple nil rate bands.

Otherwise, it may be more appropriate to establish new trusts when new CLTs are made.

Summary of conditions

SECTION 66 relief (IHTA 1984 s66(2)):

Section 66 relief will be available where:

- relevant property is added to the trust or,
- non-relevant property becomes relevant property.

Recalculation of the cumulative total (IHTA 1984 s67(2)):

It will be necessary to recalculate the cumulative total for the trust where:

- There has been a **chargeable transfer** where the “value” of the trust property increased.

Note that the value of the trust property must be increased by a chargeable transfer. For example, where the value of the trust fund is increased by the trustees accumulating, or capitalising, trust income, this is not a chargeable transfer and it would not trigger a recalculation of the cumulative total.

Note also that it is not necessary for the “amount” of trust property to be increased by the chargeable transfer, but the “value” of the trust property. For example, the settlor may waive rights or entitlements associated with the trust property. Waiving those rights or entitlements may be a chargeable transfer by the settlor and, while not increasing the amount of property held by the trustees, may well increase their value.

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