For financial advisers only

Planning with onshore bonds in trust

An adviser guide to using onshore bonds in trusts

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Planning with onshore bonds in trust

Onshore bonds are likely to be the most appropriate investment tax wrapper for many types of trust. Trust-based inheritance tax (IHT) planning is now likely to become much more popular again following the end of the IHT relief for most unused defined contribution (DC) pensions death benefits in 2027 and the cut in the relief for AIM shares.

Inheritance tax planning and trusts

Trusts can be helpful entities for estate planning where someone wants to shift assets outside their estate, but they also want to retain some control over those assets. Common reasons for using trusts are that the settlor doesn't want the beneficiaries to have unrestricted access to the funds, or they may want flexibility on who should benefit from the funds and when. There are also other reasons why trusts might provide the best solution to a legal and financial issue.

The use of trusts in IHT planning

Trusts have been widely used in the context of inheritance tax planning in the past. But in recent years, advisers have generally been using them less because other simpler and quicker alternatives became widely available, in particular:

- The death benefits from defined contribution pensions are generally free of IHT and have been able cascade down the generations. But of course, the pension member can access the benefits if it turns out that they need them.

- Investments like portfolios of AIM shares have qualified for 100% IHT business assets relief. This strategy has also allowed the taxpayer to hold an asset that has been free of tax on their death, but which they can draw from if they need money during their lifetime.

Most trust-based tax planning does not offer these best-of-both-worlds solutions, or at best can only provide them in a limited way. Pensions and business assets relief planning have until now constituted the estate planning for most of an adviser's clients.

The autumn 2024 Budget changes

This situation has now changed in the Autumn 2024 Budget:

- Most unused pension funds and death benefits payable from a pension will be brought into a person's estate for inheritance tax from 6 April 2027. So, for example, an individual with a £1million DC pension scheme that they had intended to leave to their children and grandchildren could soon have an extra £400,000 IHT liability on their estate. Many clients for whom their pension was a major part of their IHT planning may therefore now be seeking alternative planning strategies that could include drawing on the pension and making gifts in trust.

- The 100% relief on AIM shares held for at least two years before the owner's death will be reduced to 50% relief from 6 April 2026. So, the effective rate of IHT on these assets will be 20% rather than nil. AIM shares may continue to attract some investors looking for IHT saving, but the trade-off of investing in relatively volatile investments in return for a 20% tax break rather than a 40% tax saving is likely to be a lot less appealing.

Now could therefore be a good time to review the alternative tax plans that involve trusts and usually therefore onshore bonds.

The taxation of trusts

The tax treatment of trusts largely depends on the type of trust being used: a discretionary trust, or a trust where the beneficiary has an absolute right to the income and capital.

Discretionary trusts

A special tax regime applies to discretionary trusts.

The trust income is taxed at the 'Rate Applicable to Trusts' or RAT, which is higher than the rates that apply to most individuals:

- Savings income, including all bond gains, are taxed at 45%.
- Dividends are taxed at 39.35%.
- There's a tax-free band of up to £500 but:
  - The band only applies if the trust's total income in a tax year is less than £500.
  - The band is reduced where the settlor has created several trusts by dividing the £500 tax-free band between the number of trusts, with a minimum band of £100 a year.
  - If there is more than one settlor, the £500 is divided by the number of trusts created by the settlor who has created the most trusts.

Capital gains tax

Gains in trusts are generally more heavily taxed than they are on individual investors.

- The CGT rate is now generally 24% for most trusts from 30 October 2024.
- The annual exempt amount is £1,500 in 2024/25, which is half the level for individual investors. If the settlor has set up several trusts, the annual exempt amount is divided between them, with a minimum amount of £300.
- Holdover relief may be available on transfers into and out of a discretionary trust. This would effectively postpone capital gains tax on the assets.

Interest in possession trusts

Under an Interest in possession (IIP) trust at least one beneficiary has the right to receive the income generated by the trust's assets during their lifetime.

A beneficiary of an IIP trust is treated as the owner of the income generated by the trust, which is subject to tax at their personal income tax rates. There can be more than one beneficiary of an IIP trust sharing a fixed proportion of its income. The precise tax treatment of the income varies according whether the trust pays it to the beneficiary(ies) or it is mandated directly to them.

Mandated income

If the trustees decide to mandate the income directly to the beneficiary, they don't have to report it on the trust tax return. The possible drawback is that the trustees cannot then deduct their expenses from the mandated income.

Directly paid income

If the income is paid directly to the beneficiary, the trustees must deduct income tax at the basic rate from all the income, unless the trust income amounts to less than £500. The basic rates of tax paid by IIP trustees are:

- Dividend income: 8.75%
- Interest and all other income: 20%

Income tax on the beneficiary

Beneficiaries can use their personal allowance, savings rate band, personal savings allowance and dividend allowance against trust income.

- Beneficiaries who are taxed at less than basic rate can reclaim the tax paid by the trustees.
- Beneficiaries must pay basic rate tax on any mandated income from an IIP trust but not on the other income on which the tax paid by the trustees covers the basic rate liability.
- Higher and additional rate taxpayers have more tax to pay but any tax the trustees pay covers the basic rate liability.

Absolute (or bare) trusts and trusts for vulnerable people

Under an absolute or bare trust, the beneficiary has an absolute right to the income and capital once they reach the age of majority (18 years in England and Wales or 16 years in Scotland) or on earlier marriage. Bare trusts are often used to pass assets onto young people. The tax position of bare trusts is very different from that of discretionary trusts.

- Income or gains are normally taxed on the beneficiary if the settlor is not a parent.
- If the beneficiary is an unmarried minor and the settlor is their parent, the income and gains are normally taxed on the settlor parent, unless the income for the tax year comes to less than £100.

Trusts for vulnerable people

There are special tax rules for trusts for vulnerable people. These are either someone under the age of 18 whose parent has died or a disabled person who is eligible to receive Personal Independence Payments or one of various other disability-related state benefits.

Income and gains of trusts for vulnerable people are essentially taxed as if the trust income had been directly paid to the beneficiary as an individual, for whom the annual exempt amount is therefore £3,000. There is also no IHT charge if the settlor dies within seven years of setting up the trust and there's no tax charge on transfers out to the beneficiary.

The main tax features of onshore bonds in trust

Onshore bonds have several characteristics that can make them more suitable products than other wrappers. One of their advantages is that onshore bonds are not subject to the RAT and the capital gains tax regime for trusts. Other tax features of onshore bonds are:

- They can be assigned into and out of a trust without triggering a chargeable event gain – unlike mutual funds which are generally subject to capital gains tax if they are gifted (see our guide to onshore bonds for high rate taxpayers).
- Trustees can appoint a bond to beneficiaries under the age of majority to use their (often) more advantageous tax rates. They cannot assign the bond to them; instead, the trustees make an irrevocable declaration of trust that the bond, or segments of the bond, are to be held specifically for the beneficiary. The beneficiary then gets an absolute entitlement to it.
- If the trustees encash the bond or it matures in the trust, they don't qualify for top-slicing relief.
- The tax rate that applies to bonds encashed by trustees of discretionary or interest in possession trusts depends on whether the settlor is still alive at the time:
  - The settlor is taxable at their marginal rate of income tax if the gain arises during their lifetime or in the tax year in which they died. Where there are several settlors, the gain is divided between them in proportion to their contribution to the trust.
  - Otherwise, the chargeable gain in the trust is taxed at the RAT.
- It is often preferable for trustees to assign bonds to the beneficiaries, who can then choose when and how to encash them.
- In most years, bonds are investments that produce no taxable income or gains. They are therefore simple and so relatively cheap to manage and administer.

Onshore bonds allow the deferral of high rates of tax that would otherwise be payable on income from the underlying investment portfolio. The tax treatment of most trusts' income and gains is generally harsher than it is for individual taxpayers.

The main trust-based inheritance tax plans using onshore bonds

The following are brief descriptions of some of the main inheritance tax plans where onshore bonds are the only or main assets of the trusts because of their tax characteristics.

1. Discretionary gift trusts
The settlor makes a gift into a discretionary trust.

- **Provisions** The distribution of benefits is at the discretion of the trustees. The settlor of the trust should always be excluded from benefiting.
- **Income tax and CGT** is as detailed on page 3.
- **IHT** The initial gift could be subject to a tax charge, there could also be periodic charges – normally every 10 years, as well as an exit charge. These charges can usually be avoided if the transfer is within the nil rate band, depending on the trust's value at the time of periodic and exit charges. There could be a further IHT charge if the settlor dies within seven years of making the gift.
- **Onshore bond treatment** Bond gains are assessed for income tax on the settlor if they are alive and resident in UK. Otherwise, the trustees are liable for 25% tax. Assignments of a bond into and out of a trust should not trigger a chargeable event.

Example

Sarah makes a gift into a discretionary trust for her nephews and nieces and their children. The gift is invested into an onshore bond. The trustees use their discretion to distribute the trust income and assets to the children because they need the money at the present.

The value of the trust assets grow outside Sarah's estate and the gift should also normally be outside her estate with effect from seven years after the date of the gift.

2. Discretionary loan trusts

The settlor makes a loan to a discretionary trust.

- **Provisions** Like discretionary gift trusts, the distribution of benefits is at the discretion of the trustees. The key difference is that the settlor makes an interest-free loan to the trust which the settlor can access – often by drawing on the loan each year using the annual 5% withdrawal allowance to supplement their income until the loan is exhausted.

- **Income tax and CGT** is as detailed on page 3.

- **IHT** The initial loan remains part of the settlor's estate. Initial or periodic charges are unlikely. An exit charge may arise once the loan has been greatly reduced or paid off.

- **Onshore bond treatment** The trustees often use the 5% annual withdrawal facility to finance the repayments of capital to the settlor. Bond gains are assessed for income tax on the settlor if they are alive and resident in UK. Otherwise, the trustees are liable for 25% tax. Assignments of a bond into and out of a trust should not trigger chargeable events.

Example

Fred makes an interest-free loan into a discretionary trust for his children and grandchildren. The loan is invested into an onshore bond. The trustees – of whom Fred is one – use their discretion to distribute the trust income and assets to all the beneficiaries.

The value of the trust assets grow outside Fred's estate and the gift should also be outside his estate after seven years from the date of the gift. Fred receives and income in the form of an annual repayment of the loan every year at the rate of 5% of the original amount he lent.

3. Discretionary discounted gift trusts

The settlor makes a gift into a discretionary trust and retains a right to receive annual payments for the remainder of his/her life.

- **Provisions** As with discretionary gift and loan trusts, the distribution of benefits is at the discretion of the trustees. The key difference is that the settlor makes the gift into the trust, subject to a right for the settlor to receive specified regular payments for the remainder of their life – or in the case of a joint settlor, both their lives. The settlor has no other right to capital from the trust.

- The retained right to these payments reduces the value of the capital gift. The reduction in value is based on the level of the regular payments and the settlor's life expectancy at the time of the gift.

- **Income tax and CGT** is as detailed on page 3.

- **IHT** There could be an IHT charge if the settlor dies within seven years of making the gift, but it would be based on the discounted value of the gift. The initial gift could be subject to a tax charge, there could also be periodic charges and an exit charge. But these charges can usually be avoided if the transfer is within the nil rate band, depending on the trust's value at the time of the periodic and exit charges.

- **Onshore bond treatment** The trustees often use the 5% annual withdrawal facility to finance the fixed annual payments of capital to the settlor. Bond gains are assessed for income tax on the settlor if they are alive and resident in UK. Otherwise, the trustees are liable for 25% tax. Assignments of a bond into and out of a trust should not trigger chargeable events.

Example

Mo makes a gift into a discretionary discounted gift trust for his family, but he retains the right to take a fixed income from the trust assets. The gift is invested into an onshore bond. The trustees distribute the trust income and assets to the children at their discretion. The value of the trust assets grow outside Mo's estate and the gift should also normally be outside his estate with effect from seven years after the date of the gift.

If Mo were to die within the seven-year period after the gift, its value would be less than the amount he originally handed to the trustees. This discount would be based on his age and state of heath at the time of the transfer which would determine his life expectancy. The discount would also depend on the size of the annual payments the trust has to pay him.

Any questions?

If you have any questions please call us on 0333 0155600

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Financial advice

This note provides details of the structure, taxation and uses in financial planning of onshore life assurance bonds and is for your guidance only. Countrywide Assured plc (“Countrywide Assured”) accepts no liability for any action taken or not taken by an individual or firm as a result of the contents of this material.

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