WILLS PROVIDING FOR YOUNG CHILDREN

There is an age old problem presented by clients regarding how to provide for their offspring on their deaths, where the parents wish an inheritance to pass to their children in a tax efficient manner yet wish to protect their children from inheriting at an immature age. Typically, the parents wish that, after providing for the surviving spouse, the children should not inherit until each is aged, say, 25, 28, or even 30.

The implications of the taxes combined with the need for protection have not been considered in practice in any great detail to date as, fortunately, it is rare for both parents to die when their children are young. However, this will become more relevant because of separation/divorce where a sole parent wishes to provide for his children on his death alone. It is also becoming relevant as clients with significant wealth now often wish to provide that their spouse will only take part of their estate on death, with part passing to the children while the spouse is still alive. It is therefore likely that more frequently children could inherit at an age where they still require protection as it will only require the death of one parent for the inheritance to arise.

However the marriage of tax efficiency and protection is not easy and a balance needs to be drawn between them, having regard to what is best for the family as a whole.

1. Favouring tax efficiency over protection – The Bare Trust

The most tax efficient method of taking an inheritance is to give it to the child so that he takes it absolutely, i.e. without any age restriction, trust or condition. The inheritance is held in a bare trust when the child is still under 18. However this trust provides the least protection for the child.

- Legal effect

The legal effect of this for a child is that, as the child cannot give a valid receipt to the executor until he ‘comes of age’ at age 18, the inheritance is protected from the child in a bare trust until that age 18. However, once 18, the child is entitled to call on the executor(s) (as bare trustee(s)) to hand over the inheritance to him, which the child can then invest or spend as he so wishes. Most parents would be concerned that a child is not sufficiently mature at that age to receive an unrestricted inheritance.

While the child is under the age of 18, the bare trustee(s) can apply the inheritance for the benefit of the child e.g. for living expenses, education etc. It is sensible to provide in a Will of this nature that the bare trustee(s) is given significant powers to invest the inheritance and apply it for the child’s benefit while under age 18.

- Tax effect

The tax effect of this is that for CAT, CGT and income tax purposes, the child is deemed to inherit the asset at the date of death of his parent and taxed accordingly.

For CAT purposes, the usual tax free threshold (€521,208 in 2008 assuming no prior aggregable benefits) is applied to the value received and the balance is subject to inheritance tax at 20%. At age 18, when the inheritance is handed over to the child (indeed on any use of the inheritance for living expenses while the child is under 18), there are no further CAT taxes owing as it has been the child’s from the beginning.

Turning 18 is not a taxable event for CAT, CGT or Stamp Duty purposes.

The child is assessed for income and capital gains tax purposes on the income or gains made by the bare trustee(s) during the period the child is under the age of 18. The bare trustee(s) pays any such tax on the child’s behalf.

See Appendix 1 for an example of the taxation on a Bare Trust.

- Advantage

The principal advantage of this type of inheritance is the fact that the tax is paid immediately. This has a tax advantage, if one assumes that the net inheritance would be invested in a manner that would produce a better return than the Consumer Price Index (on which the indexation of the CAT tax free group thresholds is based). If so, it seems better to pay tax early on a lower amount which is then invested, than to wait until age 18 to pay the tax on a higher inheritance (because of its investment on a gross basis) without a significantly higher tax free threshold.

However some speculate that, if the tax free threshold is increased significantly above inflation (as occurred in December 1999, where there was an increase from IR£192,900 to IR£300,000), the investment returns on the net of tax inheritance might not outweigh the significant increase in the tax free threshold applying to a later greater inheritance.

- Disadvantage

The principle disadvantage to this method of providing for a child is that there is no restriction in legal terms on the child taking (and spending) their inheritance at age 18. Many young adults are not sufficiently mature at this age to handle an inheritance of significant value.

2. **Favouring protection over tax efficiency – The Discretionary Trust**

Despite the fact that discretionary trusts are considered to be tax avoidance structures (hence the additional taxes imposed on them to discourage such use), they are the best way of protecting children from taking an inheritance until each child is sufficiently mature to do so.

- Legal effect

Under such trusts the parents select trustees whom they trust to make the judgement call on the level of maturity of each child. Because of this, whom to appoint as trustees is often the most difficult matter that the parents need to decide on when making their Wills. The trustees will (or will not) appoint trust assets to the children at their absolute discretion. The parents can give a general guidance to the trustees under a letter of wishes, such as the parents' views as to when to expect the children to be mature and other instances when the parents would like appointments to be made to their children.

- Tax effect

The tax effect of this is that the child is deemed to inherit the trust assets at the date of the appointment of them to him on the exercise by the trustees of the discretion and the child is taxed accordingly. The usual tax free threshold (€521,208 in 2008 assuming no prior aggregable benefits) is applied to the value received by the child and the balance is subject to inheritance tax at 20%. However, if the trustees make payments from the trust fund for the child's living expenses, education etc. before the final appointment of the trust fund to him, there are further tax consequences to these payments as these would also be treated as taxable inheritances (unless they are exempt under Section 82(4) CATCA03 as a payment of maintenance, support or education to a child under age 18 where both parents have died).

Once the youngest child of the testator who can benefit under the trust reaches his 21st birthday, if the trust is still in place or to the extent the trust still applies to certain assets, discretionary trust levies apply (6% initial and 1% per annum thereafter, with a refund of 50% of the initial 6% levy if the trust is wound up totally within five years).

The trustees are assessed for income tax and CGT purposes on the income or gains made by the trust during the period the assets remain under the discretionary trust. An additional surcharge of 20% can arise on accumulated income. To the extent income is paid out, the child is assessed to tax on the income and can claim a credit in respect of tax paid by the trustees. The child is also treated as receiving an inheritance of the income amount received which is subject to CAT. (In such a case, concessionary relief should be sought to treat the value of this inheritance as net of income tax). The appointment from the trust to the child is a taxable event for CGT purposes, albeit that usually there is a credit available for the CAT paid. This credit would be lost if the child sold the chargeable assets received by him within two years (section 104 CATCA03 as introduced in FA2006).

See Appendix 2 for an example of the taxation on a Discretionary Trust.

- Advantage

As the child cannot say that he is entitled to an inheritance (because whether he is to receive one at all depends on the discretion of the trustees), the inheritance is protected from the child in a discretionary trust until the trustees exercise their discretion. While the assets remain in the discretionary trust, the trustees can apply capital and income for the benefit of the child e.g. for living expenses, education etc.

- Disadvantage

While the parents can hope that older children in the family will have shown sufficient maturity by the time the youngest child has celebrated his 21st birthday, so that the trustees will have appointed out their share of the inheritance before any levies arise, this may not be the case for the youngest child. The difficulty is that the youngest child does not have the same chance as his older siblings to reach maturity without the additional tax cost of the levies. However the trustees at least have the flexibility to assess the level of maturity of the youngest child in advance of his 21st birthday and appoint some, if not all, of his inheritance to him to reduce the impact of the levies if the child demonstrates a certain level of maturity by that age.

3. A sensible balance or not? The Fixed Trust

Parents may take the view that there will come a time when their child should have enough maturity or that, even if he never fully matures, the child should still take the inheritance and do what he may with it. Many Wills therefore provide that a child should take his inheritance at a particular age, typically age 25, in the hope that the extra seven years beyond age 18 would provide the child sufficient wisdom and sense to handle his inheritance.

This often arises where the parents are not comfortable with entrusting trustees with complete discretion over when their child should inherit. Where parents instruct that they would like their child to inherit at a particular age, it should be explained to them that reaching a particular age is not necessarily a guarantee of maturity - should a child take a sizeable inheritance in unrestricted form if he is not actually able to handle it? There are also ‘hidden’ taxes that make this form of trust quite inefficient for tax. Therefore this form of trust provides neither real protection or tax efficiency.

There are different versions of such fixed trusts depending on

- whether the income up to the selected age can be accumulated by the trustees; or

- whether it must be paid to the child.

• Legal effect

The legal effect of a fixed trust is that the capital of the inheritance is protected from the child until the selected age. Only at that stage is the child entitled to call on the trustees to hand over the inheritance to him to invest or spend as he so wishes. It is sensible to provide in a Will of this nature that the trustees are given powers to apply capital for the child’s benefit while under the selected age should a need arise and the income not be sufficient to meet that need.

However the income arising within the trust is not necessarily protected from the child until the selected age. Depending on how the Will is drafted, while the child is under the age of 18, the trustees can or must apply the income of the inheritance for the benefit of the child e.g. for living expenses, education etc. The protection is only available to the child if the income can be accumulated by the trustees until the selected age. If the trust does not allow the accumulation of income i.e. the trustees must apply the income for the benefit of the child, the income not yet applied to the child at regular intervals from the date of death of the parent to age 18 must be paid out in lump sum at age 18 and all future annual income must be paid out to the child at regular intervals from age 18 on. Therefore the child is not protected from any sizeable income flow from age 18 and will at 18 receive a lump sum of any income not spent up to age 18.

• Tax effect

The tax effect depends on the version of the fixed trust that applies. Assuming the selected age is 25, the following applies:

(i) Power to accumulate

Where the trustees have power to accumulate income, the trust is deemed to be a discretionary trust for CAT and income tax purposes (Section 2(1) CATCA03). On the child’s 21st birthday, as there are no other principal objects in his trust (as the child has the right to the entire fund allocated to him at age 25 and no one else is entitled to this), discretionary trust levies will arise on his fund (6% initially on the child’s 21st birthday and 1% per annum thereafter, albeit that 50% of the 6% levy will be refunded on the 25th birthday). On the child’s 25th birthday, the child is deemed to inherit the asset at that date and is taxed accordingly. The usual tax free threshold is applied to the value received (€521,208 in 2008 assuming no prior aggregable benefits) and the balance is subject to inheritance tax at 20%. The difference between this trust and the discretionary trust above is that the trustees here usually do not have the flexibility to wind up the trust to avoid the levies and must therefore pay levies, even if the youngest child is in fact mature around age 21.

In addition the winding up of the trust on the 25th birthday is a taxable event for CGT purposes, albeit that usually there is a credit available for the CAT paid. This credit would be lost if the child sold the chargeable assets received by him within two years (section 104 CATCA03 as introduced in FA2006).

The trustees are assessed for income tax and CGT purposes on the income or gains made by the trust during the period the assets remain under the discretionary trust. An additional 20% discretionary trust surcharge can arise on accumulated income. The tax effect is therefore the same as a discretionary trust, although the trustees do not have any discretion to hold back funds from the child at age 25. To the extent income is paid out, the child is assessed to tax on the income and can claim a credit in respect of tax paid by the trustees. The child is also treated as receiving an inheritance of the income amount received which is subject to CAT. (In such a case, concessionary relief should be sought to treat the value of this inheritance as net of income tax).

See Appendix 3 for an example of the taxation of a Fixed Trust where the income is accumulated.

(ii) No power to accumulate

Where the trustees do not have power to accumulate income, it is Revenue's view that for CAT purposes the child is deemed to inherit an interest in possession on the death of the parent. There are no discretionary trust levies as the income is not capable of being accumulated and the trustees do not have discretion over the capital. In such a case, assuming the child reaches age 25, this inheritance is ultimately taxed as a limited interest calculated by subtracting from 25 the age of the child at the parent's death to arrive at a calculation of a period certain (and then applying the rules in Schedule 1, Part ,1 paragraph 6, CATCA03 to arrive at the taxable value). The usual tax free threshold is applied to the value received (€521,208 in 2008 assuming no prior aggregable benefits) and the balance is subject to inheritance tax at 20%. On the child's 25th birthday, the child is deemed for CAT purposes to inherit a further absolute interest in the trust fund of the value of the trust fund at that date. The child's earlier fixed interest is aggregated with the absolute interest now taken. The usual tax free threshold is applied to the value received (€521,208 in 2008 reduced by the prior benefit taken on the death and assuming no other prior aggregable benefits) and the balance is subject to inheritance tax at 20%. In effect, there is a double charge to CAT on the same assets in the trust. This tax treatment is however uncertain as it rests on the Revenue's interpretation of the legislation in light of the case of *Jacob (Brigid Kathleen) v Revenue Commissioners [1984] 3 ITR 104,* which was settled without fully determining the issue of value.

The trustees are assessed for income tax and CGT on the income or gains made by the trust during the period the assets remain in the fixed trust. The child is also assessed on the income and can claim a credit in respect of tax paid by the trustees. The discretionary trust income surcharge does not arise.

Again the winding up of the trust on the 25th birthday is a taxable event for CGT purposes, albeit that usually there is a credit available for the CAT paid. This credit would be lost if the child sold the chargeable assets received by him within two years (section 104 CATCA03 as introduced in FA2006).

See Appendix 4 for an example of the taxation of a Fixed Trust where the income must be paid out.

- Disadvantage

As illustrated above, the typical fixed trust is quite tax inefficient either because of the discretionary trust levies (in the case of a trust where the income must be or can be accumulated) or because of the risk of double taxation for CAT (in the case of a trust where the income must be paid out). In addition such a trust does not afford real protection for a child should that child still be immature at the selected age and in respect of any income that must be paid out from age 18.

4. Recommendation

Although at first sight it may seem sensible to advise parents to take the "balanced" view between protection and tax efficiency by adopting a fixed trust structure, such a structure may not afford the tax efficiency that one would assume. Also, given the nature of a fixed trust, the protection is available only until a particular age, whether a child is mature at that age or not. It is therefore more appropriate to suggest to the parents that their assets be divided into certain asset types that would be suitable to put into a tax efficient bare trust and those that should be held back in a protective discretionary trust. Assets suitable for a bare trust could be those that are already somewhat restricted in some other way, such as assets invested in joint names with other investors or assets that are subject to mortgages where third party consents are required to sell.

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Aileen Keogan
Solicitor, McCann FitzGerald
Co-author of The Law and Taxation of Trusts (Tottels, 2007)