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INHERITANCE TAX AND TRUSTS

You may be aware that the 2006 UK Budget contained many significant proposals for changes to the taxation of trusts; most of these affect the potential inheritance tax charges. These have been confirmed in Finance Act 2006 and a brief summary of the changes is set out below.

As a result of the changes, more family trusts will suffer inheritance tax and, therefore, it is important to review the tax position in respect of existing trusts, assurance policies written in trust and plans envisaged under wills.

The new rules took effect on 22 March 2006 for new trusts but for existing trusts there is a transitional period until 6 April 2008. This allows an opportunity to amend the terms of some existing trusts so that the trust will continue to be exempt from inheritance tax.

Thankfully, the recent 2007 UK Budget contained no adverse proposals concerning inheritance tax and trusts.

Inheritance Tax and Trusts

Until these changes interest-in-possession trusts and accumulation and maintenance trusts (see below) were not usually liable to IHT, whereas discretionary trusts were broadly taxed as follows:

- Lifetime transfers into the trust are immediately chargeable to IHT at a rate of 20% to the extent that they exceed the donor's available IHT nil rate band (the nil rate band is £300,000 with effect from 6 April 2007).
- An IHT charge (known as a "ten year anniversary charge") is levied at a rate of 6% every ten years on the value of the trust above the IHT threshold.

- An IHT charge (known as an "exit charge") may also be payable when the assets leave the trust; the tax payable is calculated by reference to the position on the previous ten year anniversary or, if the trust is less than ten years old, by reference to the position on the creation of the trust.

IHT Treatment of New Trusts

Many trusts created on or after 22 March 2006 will be immediately subject to these IHT charges. This will include additions to existing trusts – the additional funds will be regarded as a new separate trust.

Fortunately, some categories of trust are excluded from the new regime as follows:

- Life interest trusts created on death (by will or intestacy) where the individual with the interest in possession became entitled to it on the testator's or intestate's death.
- Trusts created on death (either by will or under the intestacy provisions) by a parent for the benefit of his or her minor child. The child must become entitled outright to the assets in the trust upon reaching the age of 18 to avoid a tax charge: a reduced tax charge will apply to distributions from will trusts to older children (up to a maximum age of 25).
- Trusts created either on death or during a person's lifetime for the benefit of a disabled person.
- All bare trusts.

Types Of Trust

There are basically four types of trust:

- (a) **'bare trusts'** where the trustee is effectively a nominee for the beneficiary
- (b) trusts with an **interest in possession** - where someone, often called a life tenant, has a right for the time being to receive the income of the trust (although the interest may in fact end during the beneficiary's lifetime, for example, when a widow is only entitled to the income until she remarries)
- (c) **discretionary trusts**, in which no-one has a right to the income
- (d) **accumulation and maintenance trusts**, under which income is, broadly, accumulated for minor children until they reach a specified age.

Trusts In Existence At 22 March 2006

Many continuing trusts will also fall within the new rules from 6 April 2008 but others, depending on the precise terms of the trust, will be protected from the new regime for the rest of their lives. The new rules create new forms of qualifying interests in trusts and protect some existing beneficiaries' interests.

For example, interest in possession trusts that were in existence before 22 March 2006 will continue to be treated as before. If the current beneficiary's interest ends before 6 April 2008 and the trust continues for the benefit of a new life tenant (appointed before that date), the transitional rules will deem the new interest in possession to have begun before 22 March 2006. In this situation, the trust will continue to be protected from the new regime until the new life interest comes to an end.

Where a life interest ends after 5 April 2008 and a new interest starts, it will only be protected from the new regime if:

- The interest is a new life interest for the widow, widower or surviving civil partner of the deceased life tenant.
- The new life interest is in a trust created before 22 March 2006 for an insurance policy that commenced before 22 March 2006.
- The new trust is for a bereaved minor or disabled person.

Other life interests in existing interest in possession trusts created after 6 April 2008 will be subject to the new IHT rules.

Existing accumulation and maintenance trusts which specify that the beneficiaries become entitled to capital at age 18 will not be subject to the new legislation. However, if the beneficiaries do not become entitled to all the capital at age 18, the trust will fall within the new rules from 6 April 2008. Where the beneficiaries have no entitlement to capital at age 18, trustees have until 6 April 2008 to modify the terms of the trust (if this is possible or, indeed, advisable) to allow the existing favourable IHT treatment to continue.

For an accumulation and maintenance trust created prior to 22 March 2006 the new rules apply a reduced tax charge to distributions of trust capital made to children aged between 18 and 25.

Life Assurance Policies

It is a standard tax planning technique to have insurance policies "written in trust" so that on maturity (often the death of the insured person) the proceeds are paid to named beneficiaries and are kept out of the taxable estate of the settlor. Commonly, a flexible interest in possession trust is used, although discretionary or bare trusts can be used.

Such trusts will not fall within the new rules provided they were put in place before 22 March 2006 and continuing premium payments will not be treated as establishing a new trust. In addition, where a life tenant of such a trust dies, a new life tenant taking their place will also be treated as having a continuing interest that is outside the

new rules. However, new interest in possession trusts for insurance policies commenced after 22 March 2006 will be within the new IHT rules.

Estate Planning

It is clear from this overview of the new rules that wills and other estate planning put in place under the old rules will need to be reviewed to ensure that any trusts already created, or to be created, under family wills, minimise potential IHT charges. For example, it may be appropriate to make changes to the terms or beneficiaries of existing trusts, make changes to wills, and even to reconsider the tax-efficiency of existing family investments and other assets.

Such reviews involve complex technical issues and, often, difficult personal decisions, so it may take a considerable time to finalise new plans. However, many of the changes may need to be in place before 6 April 2008 to be tax-effective, so it is important to start this process as soon as possible.

It is also important for any ongoing actions involving existing trusts (for example, any payments of the trustee's liabilities by other parties) to be considered very carefully to ensure that they do not create a problem under the new rules. Families affected by divorce could also be at risk of increased tax charges if a new or existing trust is part of the settlement.

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