

## TaxZone Newthwire

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Finance Act 2006 introduced sweeping changes to the taxation of trusts. Changes had been anticipated, following consultations, but the announced changes, when made, produced protests and amazement among taxation practitioners, particularly as the extent of the changes had not been disclosed at all in the prior consultations.

As well as the draconian effect of the changes of the taxation of trusts, the accompanying legislation is extremely complex, and probably only intelligible to experts in this particular area of taxation.

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### 1. Overview of changes

Without going into too much detail, a brief summary of the current position is now that:

# There is no change to the inheritance tax treatment of discretionary trusts. Gifts into settlement are subject to an inheritance tax charge, if more than the lifetime exemption, at the time of the gift. Example 1, taken from Tolley's Tax Digest by Robert Jamieson, illustrates the continuing legislation:

#### Example 1

On 31 August 2003 Nelson set up a discretionary trust for the benefit of his brother and his brother's family. The trust assets comprised cash and quoted shares totalling £320,000.

Nelson had a cumulative total for IHT purposes of £81,000 as a result of a chargeable transfer made some five years earlier. He had made no other gifts.

The IHT payable in connection with the creation of Nelson's discretionary trust (assumed to be payable by the trustees) was:

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Unfortunately on 31 December 2006 Nelson was killed in an accident. As a result, death rate IHT tax is due in respect of the chargeable transfer on 31 August 2003. This is calculated (using 2006/2007 rates) as follows:

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# Previously a transfer into an interest in possession trust was a potentially exempt transfer, that could become completely exempt after seven years. This advantage has now been lost, making such transfers chargeable transfers in the future.

This is a simple explanation, and details of the changes and some reliefs are considered in more detail below.

# Accumulation and maintenance trusts also enjoyed similar advantages to interest in possession trusts. These advantages have now been abolished, making transfers into such trusts potentially chargeable to inheritance tax.

There is also a provision whereby the funds of existing trusts should become the property of the beneficiaries at age 18 rather than at age 25. This is also discussed further in Newthwire No. 115.

# Changes have been made to the legislation regarding disabled trusts, some of which are useful in clarifying the type of potential beneficiary who can benefit.

It should be noted that, although the legislation is not exactly retrospective in itself, it has consequences for trusts in existence before Finance Act 2006 became law.

### **Planning point**

**Accountants should note the sweeping changes in the trusts legislation. Where their clients have existing trusts they should advise on the effects of the new legislation on such trusts.**

## **2. New legislation**

# The new meaning of settlor for income tax and capital gains tax purposes is set out in section 685B, Taxes Act 1988 and section 68A, TCGA 1992, and applies from 6 April 2006.

# An election may now be made to treat a 'sub-fund' as a separate settlement. The provisions are set out in section 685G, Taxes Act 1988 and Schedule 4Z to the TCGA 1992. An election may be made from 6 April 2006, and once made it is irrevocable.

# In connection with settlor interested trusts section 169F, TCGA 1992 has been amended to include the wider meaning of settlor. Accordingly, it is not possible to hold over gains into a trust where the settlor's dependant children can benefit.

# Schedule 20 to the Finance Act 2006 contains the most controversial part of the new legislation, and makes the most fundamental changes to inheritance tax for 20 years. In outline the changes mean:

(1) Post budget interest in possession trusts will now be taxed as if they were discretionary trusts unless they meet certain criteria.

(2) Those criteria can never be satisfied by a trust created in the settlor's lifetime.

(3) Even a trust created on death can only satisfy the criteria if it provides for an interest in possession trust to arise on the settlor's death, although the conditions are now less harsh than those originally announced, which would have denied spouse exemption in many cases.

(4) Accumulation & maintenance trusts will only keep their pre-budget privileges if they pass assets outright to beneficiaries at age 18. Otherwise existing A & M trusts will face a charge at up to 4.2 per cent if they defer outright entitlement to age 25.

(5) Potentially exempt transfers will no longer be possible, except to individuals or disabled persons' trusts.

(6) All this creates major problems for divorce situations, life policies and many other areas of planning.

Other references to new legislation will be made under the specific headings below.

## **3. Life interest trusts**

Life interest trusts, or interest in possession trusts, where interests arise on or after 22 March 2006, will fall outside the previous treatment of life interest trusts unless they fall within some very narrow categories of 'protected' trusts. Paragraph 4(1) of Schedule 20 to the Finance Act 2006 achieved this by

stating that it is only these narrow categories of interest in possession trusts to which section 49(1), IHTA 1984 will now apply. Section 49(1) is the rule which treats the assets in which someone has an interest in possession trust as if he or she was beneficially entitled to them.

Accordingly, disapplying section 49(1) to any particular assets held in a life interest trust means that:

# The assets will not be contained in the person's taxable estate at death (s 5(1), IHTA 1984). In addition where assets are left on a life interest for the spouse of the deceased, they will not be deemed to be comprised in the estate of the spouse (s 18(1), IHTA 1984).

# The assets will fall into the discretionary trust regime because they will be 'relevant property', because no 'qualifying interest in possession' will exist (s 58(1), IHTA 1984).

A new section 49(1A), IHTA 1984 lists three limited situations where an interest in possession trust will remain within the pre FA 2006 rules, even though the holder became entitled to it on or after budget day. These are:

- (a) Immediate post-death interests;
- (b) Transitional serial interests; and
- (c) Disabled person's interests.

#### **a. Immediate post death interests**

Immediate post-death interests are defined by a new section 49A, IHTA 1984. These interests must meet all the following conditions in relation to the life tenant:

# The settlement must be effected by the will or intestacy rules. This immediately rules out any life interest trusts created during the lifetime of the settlor.

# The life tenant must have become beneficially entitled to the interest in possession on the death of the settlor or intestate person.

# The interest in possession must not be a bereaved minor's or disabled person's interests.

It will still be important to review existing wills of clients, particularly elderly clients, to ensure that trusts created by wills still qualify. It should be noted that a will trust commences on death, not when it was drawn up. This means that a will drafted many years ago may create a post 2006 budget interest in possession.

Note also that if a post 2006 budget life interest trust for a spouse comes to an end on the death of the spouse, but is then followed by a further life interest trust for children or other beneficiaries, there will be an IHT charge on the death of the spouse and the trust for the children will be treated as a discretionary trust. Another point to watch is that a transfer to a life interest trust for the benefit of the settlor will now be a chargeable transfer. Previously it was not an event for IHT purposes at all.

#### **Planning point**

**Practitioners should note the very narrow qualifying conditions for post 2006 budget life interest trusts. It is also important to review carefully the implications of the new legislation on existing life interest trusts and the wills of clients should be carefully reviewed, particularly where they are elderly persons.**

#### **b. Transitional serial interests**

Transitional serial interests apply to interests ending between 6 April 2006 and 5 April 2008. As originally drafted, TSIs were defined in a new section 49C, IHTA 1984 and apply where:

- # The settlement commenced before budget day 2006 (22 March 2006);
- # Immediately before that date an individual had a life interest trust;
- # That prior interest comes to an end on or after 22 March 2006, but before 6 April 2008;
- # On that coming to an end, another life interest trust arises to which someone, whether or not the previous beneficiary, is beneficially entitled; and
- # That interest is not a disabled person's or bereaved minor's interest.

The original TSI legislation was amended at report stage, principally to provide that there is a special relief for spousal TSIs after 5 April 2008. The limited extension of the TSI concept is set out in section 49BB, IHTA 1984, which applies where:

- # A person is entitled to an interest in possession under a pre 2006 budget day settlement;
- # The interest comes to an end on the death of the individual;
- # The death occurs after 5 April 2008;
- # On the death of the original beneficiary there is a new life interest for a person who was the spouse or civil partner of the beneficiary immediately before his or her death;
- # The beneficiary on the death of the individual is not a bereaved minor or disabled person.

The consequences of the extended provisions are that the interests of the spouse or civil partner continue to benefit from the pre 22 March 2006 rules. The transfer from original beneficiary to spouse or civil partner would be exempt under the spouse exemption rules.

It should be noted, however, that the extended relief beyond 5 April 2008 applies only when succession applies on death. The general relief in the original legislation, where the succession occurs before 6 April 2008 can be made where the interests are passed to any nominated person, and do not necessarily rely on the death of the life tenant. As the 'spouse TSI' only applies on death, it is of no assistance in divorce proceedings after 5 April 2008.

It is understood that it is possible to terminate an existing interest in possession before 6 April 2008 in part rather than in whole. Alternatively a single IIP trust for a spouse could be turned into three IIP trusts for each of three children taking one third each, provided all three interests commence at the same time.

### **Planning Point**

**Accountants should note the opportunities available to pre 22 March 2006 IIP trusts, provided action is taken before 6 April 2008. It might be possible to use that facility in order to prolong the life of a trust that has substantial unrealised CGT liabilities.**

### **c. Disabled persons interests**

Disabled persons interests are defined in para. 6 of schedule 20 to the Finance Act 2006. Some amendments are made to section 89, IHTA 1984, but basically 'disability' is defined to include mental incapacity or physical disability sufficient to attract attendance allowance or disability living allowance. The section has been extended to include persons who would qualify for such state benefits but for the fact that the individuals are non-UK resident or are in accommodation paid for by a local authority.

A new section 89A, IHTA 1984 now extends to the disabled persons' regime a trust created by a settlor post 22 March 2006 in the following circumstances:

# He or she satisfies HMRC that when the assets were settled, he or she had a condition that it was reasonable to expect would lead to him or her becoming disabled;

# The trust provides that there is no interest in possession in the settlor's lifetime;

# An application of the trust assets in the settlors' lifetime is for the settlor's benefit; and

# If there is any power to terminate the settlement in the lifetime of the settlor, either he or she or some other person must then take an absolute entitlement, or a disabled person's interest will exist.

Section 89A caters, for instance, for persons with the early stages of Alzheimer's disease, where a person has the mental capacity to make a settlement that will protect his or her assets.

Additional measures were introduced at the report stage of the 2006 Finance Act, as follows:

# The new provisions apply to disabled trusts where the property was transferred into the settlement before 22 March 2006, so long as the disabled person's interest arises after that date; and

# No IHT charge arises when someone settles assets on themselves under a disabled person's trust that fulfils the conditions of section 89A, IHTA 1984.

Trusts that meet the rules are normally discretionary in format but are deemed for IHT purposes to be interest in possession trusts in accordance with section 89(2). The trusts therefore avoid the ten yearly charge, although any remaining assets are taxed on the death of the disabled beneficiary. Privileged disabled trusts of this type can be set up in lifetime and not just under a will.

## **Planning point**

**Practitioners should note the subtle differences to the regime for disabled trusts, including the facility of a disabled settlor to set up a trust for his or her own benefit.**

### **d. Consequences of new legislation**

There are substantial consequences to the new regime regarding interest in possession trusts, following Finance Act 2006.

# Pre 22 March 2006 interests in possession

Life interest trusts in existence at 22 March 2006 retain their status while the pre-Budget Day interests remain in being, however long the life tenant survives. The result of this are:

- (1) No ten-yearly charges are imposed under the inheritance tax rules; and
- (2) The assets are taxed on the death of the current life tenant; but
- (3) If on the death of the life tenant there is a succeeding life interest, this falls into the discretionary trust regime, unless the death occurs before 6 April 2008 when the succeeding interest also falls within the former favourable IIP trust rules or where the succeeding interest is to a spouse, even if death occurs after 5 April 2008.

An additional point is that, if on the death of the life tenant the assets pass outright to their spouse, then the IHT spouse exemption is due in the normal way.

# Post 22 March 2006 interests in possession

Post 22 March 2006 interest in possession trusts that are not 'protected' will fall into the existing discretionary trust regime unless they are come within the 'bereaved minors' rules (see below). Accordingly:

- (1) Transfers into trust will be immediately chargeable and not potentially exempt transfers;
- (2) Ten-yearly IHT charges will apply; and
- (3) IHT exit charges will also apply potentially.

The imposition of IHT will, of course depend also on the availability of the nil-rate band, and the possibility of claiming business property relief and/or agricultural property relief. The good news, however, is that on the death of the life tenant there will be no IHT because the trust assets will no longer be part of the estate.

Example 2, also taken from Tolley's Tax Digest by Robert Jamieson, illustrates the effect of the new legislation.

#### Example 2

Cochran set up a life interest trust for his wife Sharon on 1 June 2006. Cochran's chargeable transfers prior to the creation of this trust totalled £200,000 and the value of the assets going into the trust was £506,000.

Following Cochran's death in a car accident on 17 April 2017, Sharon remarried on 3 October 2020 and, under the terms of the trust, her life interest terminated. The trust capital went to the three children absolutely.

On the assumption that the trust property had the following values:

- (1) £760,000 on 1 June 2016; and
- (2) £890,000 on 3 October 2020

and that the 2009/2010 tax rates apply to all the transactions after the initial setting up of the trust, the IHT payable in respect of this trust is as follows:

Creation of trust on 1 June 2006

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Thus:

$$127,000/760,000 \times 100\% = 16.7105\%$$

The rate of IHT actually charged is:

$$16.7105\% \times 30\% = 5.0132\%$$

Therefore the trustees must settle an IHT liability of  $5.0132\% \times 760,000$  making £38,100. Under the old rules there would have been no 10 year anniversary charge.

Termination of trust on 3 October 2020

The value of the property leaving the interest in possession trust on 3 October 2020 following Sharon's remarriage is £890,000. This will be taxed as an exit charge under section 69, IHTA 1984.

The rate of IHT ascribable to this transaction is:



$5.0132\% \times 17/40$  making  $2.1306\%$

If the tax on this appointment is paid by the three children, the liability will be:

$2.1306\% \times 890,000$  making £18,962

Under the old rules this appointment would have been treated as a potentially exempt transfer made by Sharon and so IHT would have only been due if she had died within seven years of 3 October 2020.

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### Planning point

**Accountants should note the draconian measures that will apply to post 22 March 2006 IIP trusts, and advise their relevant clients accordingly.**

## 4. Conclusion

Accountants will now be aware of just how complex the new trust legislation is. In Newthwire No. 115 I shall consider the new regime for accumulation and maintenance trusts in detail, as well as '18–25 trusts' and bereaved minors' trusts.

## Ask a question

Readers with a current case should post their query in Any Answers.

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