

Guidance Note - Trusts

A question of trust

Having stayed relatively unchanged for two decades, the inheritance tax (IHT) treatment of trusts is very different following the Finance Act in July 2006.

The main changes

The inheritance tax regime previously in place for interest in possession (IIP) trusts and accumulation & maintenance (A&M) trusts has been significantly changed and most of these trusts will now be taxed under similar rules to those which have always applied to discretionary trusts.

Lifetime transfers to an IIP or A&M trust made on or after 22 March 2006 are no longer potentially exempt transfers (PETs) and as a result they will not escape IHT if the donor survives seven years. Instead, such transfers will be immediately chargeable to IHT to the extent that they exceed the Nil Rate Band, currently £285,000, at the lifetime rate of 20%.

Assets held in IIP trusts set up after the Budget are no longer deemed to be part of the estate of the life tenant. This could lead to an IHT charge every ten years based on the value of the trust assets, and an exit charge either when the trust comes to an end or when assets leave it.

There are a small number of 'protected IIP trust interests' which are not subject to the new rules, notably Immediate Post-Death Interests (IPDI), Transitional Serial Interests and Disabled Person's Interests, of which more later. Furthermore some pre-existing A&M trusts can continue to benefit from the new rules although in many cases their terms will have to be changed.

Interest in possession trusts

There are three types of trusts that are protected from the changes. The most common of these is likely to be the IPDI. This protection applies where the settlement is effected by Will or intestacy in favour of a spouse, ruling out IIPs created in their favour during the settlor's lifetime.

When a post-Budget IPDI for a spouse comes to an end on the spouse's death, and is followed by a new IIP for children or other beneficiaries, there will not only be a charge on the spouse's death, but also the new IIP will be taxed as a discretionary trust because it won't have come into existence on the settlor's death.

Transitional Serial Interests in trusts which existed on 22 March are exempt from the new rules. These apply where one life tenant succeeds another (whether or not on death and regardless of the relationship between them) before 6 April 2008, or after that date if the succession takes place on death and the successor is a surviving spouse or civil partner. In both cases the succeeding life interest will be taxed under the present rules. If the successive life interest comes into existence after 5 April 2008 the new rules will apply from that date unless the existing trust held a life policy only and the policy terms remain the same as they were on 22 March.

Disabled Person's Interests are trusts where the beneficiary is disabled or it is clear they will become so, and these will continue to be taxed under the old rules.

A&M trusts

The only post-Budget A&M trusts which can maintain the old style tax advantages are those for Bereaved Minors, persons under the age of 18 who have lost at least one parent, which arise on that parent's death.

Any pre-Budget A&M trust will continue to benefit from the old rules if before 5 April 2008, the terms of the trust allow, or are altered to allow, the beneficiaries title to capital outright at the age of 18. Since very few existing A&M trusts provide for assets to pass outright at or before 18, in practice this means that trusts will have to amend their terms by 5 April 2008 if they are to continue to qualify.

Many trustees and settlors will be uneasy about allowing young adults to have access to trust funds at the age of 18 so an alternative called the '18 to 25' regime has been introduced. There will be no charge at age 18 if absolute entitlement is delayed until age 25 (at the latest), at which time there will be a tax charge at a rate of up to 4.2%. In many instances the tax rate will be lower than this so this option should be carefully considered.

What now?

- Review your Will to determine whether your expectations can still be achieved without giving rise to any unexpected tax liabilities.
- Consider the IHT impact where there is no surviving spouse.
- Consider whether to use '18-25' trusts and whether any of the protected categories are applicable.
- Where death has already occurred, consider whether Deeds of Variations will assist.
- Review A&M trusts and decide whether any steps need to be taken before 5 April 2008.
- Consider alternative forms of planning using, for example, AIM stocks, woodlands or farmland? Is a more appropriate non-trust holding vehicle available?

If you would like to arrange a free no obligation meeting to discuss the above changes please contact John Lang Director Tower Hill Associates Limited on 020 8891 6375.