

CLIENT MEMORANDUM

TAXATION OF TRUSTS: GORDON BROWN'S BOMBSHELL

The main taxation treatment of trusts has stood the test of time well, having been broadly unchanged for approximately 25 years. Then, quite unexpectedly and without any mention at all in the Budget Speech, there was an announcement amongst this year's Budget notices which will result in a very substantial change to the inheritance tax treatment of virtually all lifetime trusts, and many of those made by will on death.

As with all major changes in the realm of taxation, there are winners and losers, although on this occasion there are far more situations where the tax position is worsened than those where there is an improvement. Nevertheless, the new rules open up a few tax saving opportunities and no doubt these will be the focus of much attention for the future, until such loopholes as there may be are closed off by amending legislation. This memorandum shows how the rules have been changed, and highlights what steps now need to be taken in relation to existing trusts, as well as offering an outline of the tax planning opportunities which have now been opened up.

It should be noted that there are special rules for certain trusts, such as trusts for the disabled, trusts for the maintenance of historic buildings, but as these are rather specialist they are not covered in this memorandum.

Types of trusts

There are broadly three types of trusts which are used in the context of financial and tax planning for the family. These are:

Discretionary trusts

Under this type of trust, funds are held by trustees to be applied as to both capital and income at their discretion from time to time. If they should choose to do so, they could accumulate the

income and not pay it out at all, although accumulation periods exceeding 21 years are void under trust law. Trustees can be members of the family, although often a professional trustee will be appointed to act with them. There is no reason why the person making the trust (the settlor) cannot be one of the trustees and in any event he or she will usually offer guidance to the trustees as to how he or she wishes the funds to be applied from time to time.

Life interest trusts

A life interest is known as an interest in possession in the inheritance tax legislation and under this type of trust the life tenant has an entitlement to receive the income as and when it arises. His or her interest need not be for lifetime and can be for a shorter period; for example a trust might start off as an accumulation trust (see next paragraph below) and then when beneficiaries become of age they may have an entitlement to receive the income until they are 25 or 30 when they may be entitled to receive the capital. Whilst they are entitled to the income, those beneficiaries have an interest in possession until such time as they have full entitlement to the trust assets.

Accumulation and maintenance trusts

These are trusts typically utilised for infant children, which were given an exemption on the introduction of capital transfer tax (now inheritance tax) by the Finance Act 1975 where no potential beneficiary had a vested interest. There are detailed rules applicable to them, but in broad terms they are normally trusts for one generation of infant children in a particular family each of whom must become entitled either to the trust assets on attaining the age of 25 (or earlier) or at least entitled to receive the income at that time.

Previous tax treatment

Until this year, no inheritance tax was payable when funds were transferred during lifetime into interest in possession or accumulation and maintenance trusts. Instead, the funds transferred in were initially treated as exempt transfers, although this status would be lost and they would become chargeable transfers on the settlor's estate should he or she die within seven years of making the gift.

On the other hand, discretionary trusts fell under a different régime. Funds transferred into a discretionary trust were always chargeable transfers so that inheritance tax at the lifetime rate (20 per cent) would be payable on the excess of funds transferred in over and above the available settlor's nil rate band, which is currently £285,000. So, for example, if a settlor has already made chargeable transfers of £185,000 in the past seven years, and he then transfers £200,000 into a discretionary trust, he would have £100,000 of his nil rate band available against the transfer to the new trust and the balance of £100,000 would incur inheritance tax at 20 per cent, tax payable £20,000.

Capital gains tax

If investments or other chargeable assets are transferred into a trust, that amounts to a disposal of those assets for capital gains tax purposes by the settlor, treated as made at market value. Therefore a capital gains tax position arises, and if the assets are standing at a profit over their cost price plus, if appropriate, indexation up to April 1998 (being an allowance for inflation) the settlor would have a capital gain to disclose on his self assessment tax return form. For discretionary trusts, there was provision for any gain to be 'held over' into the trust if the

settlor so elected, and by this means he could avoid incurring any capital gain, but instead the trustees would take on the settlor's indexed base cost. This hold over was not, however, available if either the settlor or his spouse was a possible beneficiary under the trust. For life interest and accumulation and maintenance trusts, there was no general hold over relief before the 2006 Budget, although a more limited relief of a similar type is available for business assets, such as shares in an unquoted trading company. Once again, this relief is not available for settlor-interested trusts.

Recent changes

There are major changes to both the inheritance tax rules with effect from 22 March 2006 and capital gains tax rules from 5 April 2006 described above, subject to any final changes made to the proposals during the passage of the Finance Bill through Parliament. First and foremost, the distinction between discretionary trusts and other types of trusts for inheritance tax purposes is to be swept away, and all trusts will fall under the régime previously applying only to discretionary trusts. This means that the settlor will incur an inheritance tax liability on making the trust at the rate of 20 per cent on the excess of value transferred to the trust over his or her available nil rate band. This régime will apply to children's accumulation and maintenance trusts as well as life interest trusts and discretionary trusts and undoubtedly this will be seen as a major disincentive to forming any new family trusts.

However, the inheritance tax position is not quite as penal as it might seem at first sight. This is because previously the funds in a life interest trust were treated as part of the estate of the life tenant, so that on the death of the life tenant the settled funds would be counted in with the life tenant's personal assets in establishing whether inheritance tax was payable on them at that time. Very often this would mean that a 40 per cent liability then arose. This will no longer be the case in future, since the rule is now to be that no trust funds are aggregated with the estate of any beneficiary.

Instead, the tax régime previously applying to discretionary trusts will now apply. Under this régime, charges on the trust funds arise every ten years according to a rather complicated formula with the maximum rate of tax being six per cent. Very often the effective rate is lower than this, even if the funds in the trust are considerably in excess of the nil rate band. On winding up the trust, a proportionate inheritance tax charge arises at the same effective rate as applied on the previous ten-year anniversary, the proportion being the fraction of the ten-year period following that anniversary which has elapsed since the last ten-yearly charge.

Overall, this régime is designed to produce broadly the same inheritance tax position as would apply if the funds were in the estate of an individual. Thus, in an individual's estate, 40 per cent tax might be payable every generation, but in a discretionary trust 20 per cent might be payable on making the trust and then, say, four ten-yearly charges at a maximum of six per cent which might be not much different from the 40 per cent charge on individuals. The capital gains tax position of discretionary trusts is slightly more favourable than those of life interest or accumulation and maintenance trusts. The general hold over relief already described is available when the discretionary trust is wound up, but previously life interest trusts did not enjoy this general hold over relief, although in most circumstances there was a tax-free uplift to market value for the assets in the trust on the death of the life tenant. That will no longer apply for trusts made under the new régime, but instead the general hold over relief for capital gains tax will be available. By this means, the beneficiaries receiving the assets may be able to take them at their cost prices to the trustees.

Existing trusts

The new rules will not apply to life interest trusts in existence at 22 March 2006. In such trusts it will be permissible to replace the existing life interest with a new life interest before 5 April 2008.

The new rules will also not initially apply to existing accumulation and maintenance trusts. However if they are to remain free of inheritance tax beyond that 5 April 2008 the terms of such trusts must be amended before that date to ensure that the children become entitled to their share of the capital held for them upon attaining the age of 18. Alternatively the trusts can be amended (if necessary- some may already provide for this) to ensure that the capital must be paid out to beneficiaries on or before attaining the age of 25; in that event a small inheritance tax exit charge, not exceeding 4.2 per cent, will be incurred on the amount of any capital paid out to a beneficiary after attaining the age of 18. Any trust which after 5 April 2008 permits funds to remain in trust for beneficiaries after they attain the age of 25 will lose its existing privileged status and will thereafter be treated in the same way for IHT as a discretionary trust, as detailed above.

There is no change for existing discretionary trusts and these all continue to operate under the tax rules previously laid down.

Settlor-interested trusts

In the past, it has been the case that the settlor-interested discretionary trust (namely a discretionary trust in which the settlor can benefit) has had a highly unfavourable inheritance tax régime and so such trusts were basically off the agenda. The problem now is that all new trusts will fall under the previous discretionary trust régime for inheritance tax purposes and trusts in which the settlor is to have an initial life interest have been very common in recent years for various financial or tax planning purposes. These will now fall under the harsh discretionary trust régime and in general they are unlikely to be worthwhile. The main exception will be where the funds are within the settlor's available nil rate band (currently £285,000) when no inheritance tax will be due on setting up the trust and ten-yearly charges might also be minimised.

Capital gains tax hold over relief has not been available since December 2003 for settlor-interested trusts. For the purposes of this tax the definition of settlor interested is wider and includes a trust where the settlor's spouse is a potential beneficiary. Unfortunately the definition is being extended further with effect from 5 April 2006 and, in future, any new trust which is set up for the settlor's infant children will be treated as a settlor-interested trust. This means that capital gains tax hold over relief will cease to be available for these trusts. This package of proposals will clearly operate as a major disincentive to parents putting funds into trust for their children, since both capital gains tax and inheritance tax may be due on forming the trust.

Review of existing trusts

It will clearly be important to review all life interest and accumulation and maintenance trusts over the next two years to ensure that their existing favourable inheritance tax position is preserved for as long as possible. Smaller trusts may not be affected to any degree, as the funds may be insufficient to give rise to inheritance tax liability in any event. But with life interest trusts it may be thought appropriate to extend the current tax position by replacing the

current life interest with a new life interest in favour of a younger member of the family. This of course will require a detailed review of the financial position of the family as a whole.

New trusts

Equally, new trusts where the funds are within the available nil rate band will not be affected to any great degree. In future therefore it may be important to make sure that wealthy members of the family make full use of the fact that their inheritance tax 'clock' is re-set to zero every seven years so that a new nil rate band then becomes fully available once that time has elapsed since any previous chargeable transfer.

There are various exemptions from inheritance tax. In particular there is 100 per cent business property relief for shares in unquoted trading companies so that no inheritance tax liability arises if such assets are transferred into a trust. After two years ownership, the trust should qualify for the same 100 per cent relief. Another relief which is commonly overlooked is the relief for normal expenditure out of income. Therefore a person with substantial income may be able to make sizeable gifts into trust every year without any inheritance tax liability arising at that stage. In this way, funds can, over a period of years, build up in trust for the family and under the new rules these funds will only incur six per cent ten-yearly charges, and there will be no charge on the death of any life tenant under the trust. That will be a more favourable position than is obtained under the rules as they applied in the past.

There is also an exemption for divorce settlements, particularly where under Court Order, as these are not regarded as being made with gratuitous intent. In future, it will probably be better for the funds passing between divorcing parties to be settled on trust for the other so that no inheritance tax liability will be payable at that stage, and from then on only six per cent charges can arise. If the funds had passed to the estate of the divorced spouse, the ultimate inheritance tax liability could have been 40 per cent.

There are various other reliefs and exemptions from inheritance tax, mostly available in fairly specialist circumstances, but it will in future be most important, where a relief is available, to put it to the best use, perhaps by making a gift into trust for an individual rather than to the individual outright.

We can advise on how best to take advantage of the new rules in the light of your own personal finances and circumstances.

FOR GENERAL INFORMATION ONLY

Please note that this Memorandum is not intended to give specific technical advice and it should not be construed as doing so. It is designed merely to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.