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Stop Press - Finance Bill (No.2) 2006 - Inheritance Tax and Trusts

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CATEGORY:
ARTICLE

Our Stop Press dated 22 March 2006, a copy of which is attached, discussed the changes announced by the Chancellor in his Budget affecting the private client world and in particular the inheritance tax treatment of trusts.

The Finance (No.2) Bill 2006 issued today contains few surprises and shows scant regard for the issues that have been highlighted in the forceful representations made by various professional bodies, including the Law Society and the Society of Trusts and Estates Practitioners, over the past weeks.

The draft legislation confirms, with few concessions, the Government's intention to go ahead with the draconian proposals set out in BN25 'Aligning the Inheritance Tax Treatment for Trusts'.

Wills

Much has been made of the potential impact of the new regime on standard will planning.

Only clients with the simplest form of will remain untouched by the new regime for trusts contained in the draft legislation. In short, any will that does not confer an absolute interest on the surviving spouse or civil partner with a default gift to children at 18 (or other absolute default gifts) will need to be reviewed and is likely to require change.

Of great concern following BN25 was that a will conferring a life interest (rather than an absolute entitlement) on a surviving spouse or civil partner would not qualify for exemption from inheritance tax. The draft legislation contains some relief from this concern in the form of an ability to create by will a restricted form of life interest which can secure the inheritance tax exemption. The rules are, however, strict and will be breached by the existence of an overriding power of appointment or advancement (including the statutory power) if that power can be exercised otherwise than by, or with the consent of, the life tenant. Equally, on the death of the spouse or civil partner the residue of the deceased's estate will normally need to pass to the remainder beneficiaries absolutely (or at the latest by age 18) if the inheritance tax exemption is to be available.

The type of life interest commonly conferred on a spouse or civil partner under a flexible will is unlikely to qualify for this more beneficial treatment. However, individuals who have wills in this form do not need to make rushed changes. It is clearly the intention of the draft legislation that will trusts that do not qualify for the special treatment can be rearranged in a tax efficient manner within two years of death provided the trustees have the necessary powers.

In the absence of such powers it may still be possible to vary a will, although this may be a costly and time-consuming exercise particularly if the interests of minor beneficiaries are affected, as an application to the Court will then be necessary.

Trusts for Young People

Despite the many representations that have been made, it seems that the Chancellor is resolute in his view that it is appropriate for young people to receive potentially significant sums of money absolutely at the age of 18. Many see this as the most damaging consequence of the new regime.

The draft legislation confirms that new trusts for young people can only be made in a tax efficient manner in very limited circumstances. Any new trust (other than a bare trust or a trust for a disabled person) made during the settlor's lifetime will trigger a charge to inheritance tax at 20%. All such trusts and any trusts made on death, unless they are made by will by a deceased parent for minor children who will become absolutely entitled to the trust assets at the age of 18, will suffer periodic charges to inheritance tax (currently at no more than 6%) while the trust remains in being.

Existing trusts for young people can continue in their current form until 6 April 2008, after which date they will become subject to periodic inheritance tax charges. The draft legislation contains transitional rules intended to enable the reorganisation of existing trusts before this date, but the effect of these rules is unclear. In particular, it is not certain how the transitional rules apply where a beneficiary attains the age of 18 between 22 March 2006 and 6 April 2008.

Unfairness may also ensue where beneficiaries fall to be taxed under different regimes because their beneficial interests differ at the relevant dates because of their respective ages. There will no longer be a level playing field for the beneficiaries of existing accumulation and maintenance trusts.

There is no scope for grandparents to establish tax favoured trusts, other than bare trusts, for their grandchildren under the new regime.

It is also ironic that trusts for young people which satisfy the new inheritance tax regime will fall within the 'charge on settlor' provisions for capital gains tax purposes with a consequent loss of business asset or agricultural property holdover relief on a gift into trust. The ability to holdover in relation to business assets and agricultural property on a transfer out of trust will remain.

Other Trusts

Life Interest Trusts

Disappointingly, even the limited concessions for life interest trusts created by will are not preserved for life interest trusts created during the settlor's lifetime.

As with trusts for young people, there is a window of opportunity to reorganise existing trusts before 6 April 2008 and clients should take advice on their specific circumstances, particularly if their current expectation is that inheritance tax exemption will apply on the death of the existing life tenants by virtue of their spouses or civil partners taking successive life interests. It will be critical to review all existing trusts of this type and ensure that they are subject to the best available regime going forward.

The draft legislation makes it quite clear that funding new life interest trusts post 22 March 2006, and adding additional funds to existing life interest trusts, will now trigger an immediate charge to inheritance tax (at 20%).

The new regime will apply in respect of self settled trusts and trusts established for the settlor's spouse. There is no scope for a vulnerable individual (who is not a disabled person for the purposes of the regime) to protect his assets by placing them in tax-favoured trust for his own benefit.

It should also be noted that in the future there will be no tax free rebasing of the trust assets for capital gains tax purposes on the death of a life tenant.

Insurance and Death Benefit Trusts

In the guidance note issued by HMRC in tandem with the Finance (No. 2) Bill 2006, it was stated that the current rules will continue to apply where life insurance has been written into trust prior to 22 March 2006 and regular premiums continue to be funded. The draft legislation, however, appears to be silent on this point and so it must be assumed for the time being that additions to these trusts will in fact be subject to the new regime.

Many insurance companies' standard forms create life interest trusts over life policies and all of these trusts are potentially affected by the new regime. The tax treatment of bespoke discretionary trusts will not be changed.

Similar issues will arise in respect of death benefits written into trust.

Most individuals view insurance and death benefits as forming an integral part of standard death planning. The trusts do not have, and are not intended to have, any lifetime effect. The application of the new regime in these circumstances will therefore undermine basic death planning techniques employed by individuals up and down the country.

Gifts with Reservation of Benefit and Trusts

Where an individual continues, by virtue of a life interest, to be treated as owning underlying trust assets for inheritance tax purposes under the new regime, the termination of that interest will, under the new provisions, constitute a gift for the purposes of the rules relating to gifts with reservation even if the life tenant does not play an active part in the termination of the interest. If the individual continues to enjoy the benefit of the assets (whether in practice or by virtue of being a member of a wider class of beneficiaries) the assets will be treated as if they remained comprised in his estate for inheritance tax purposes.

We face a challenging new regime where families will be presented with starker choices between trusting their children and giving money away outright or paying a tax premium to secure continued flexibility and control.

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