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Finance (No. 2) Bill 2006

12 JUNE 2006

CATEGORY:
ARTICLE

In our Stop Press of 7 April 2006 we summarised the provisions of the Finance (No. 2) Bill 2006 designed to give effect to the sweeping changes to the inheritance tax ('IHT') treatment of trusts announced on Budget Day (22 March 2006).

Since that Stop Press was issued, further representations have been made by the Society of Trust and Estate Practitioners (STEP) and by the Law Society and other professional bodies, and we are pleased to note that the Government has now amended its original proposals in a way which should mean that fewer people need to radically rethink their estate planning.

Overview

The proposed Government amendments which were tabled on 8 and 9 June 2006 affect

- The availability of IHT exemption where wills confer life interests on spouses or civil partners.
- Existing accumulation and maintenance trusts and new trusts created by will for the testator's children or step-children.
- New trusts settled by settlors who expect to become disabled.
- Existing trusts which hold life insurance policies.
- The ability to vary post-death the terms of existing wills the terms of which do not achieve the optimum tax treatment.

The changes have been widely misreported in the press as a Government U-turn – in our view, the effective re-instatement of the spouse exemption is of huge importance and represents a victory for common sense; the other changes are more modest in scope but to be welcomed. What has not changed at all is the fiscal discrimination against the use of trusts as a vehicle for estate planning – with limited exceptions, there is a tax premium in the shape of an up-front 20% charge to IHT and charges at 6% every 10 years on value in excess of the nil rate band when compared with outright gifts.

Exemption for life interest trusts coming into existence on death under wills or the intestacy rules

The proposed amendments mean that full IHT exemption will continue to be available where wills provide for property to be held on life interest trusts for the testator's spouse or civil partner, even where the spouse's or civil partner's interest is capable of being overridden by powers conferred on the trustees or where that interest is followed by a trust for other individuals. The original proposals required that, if a life interest conferred on a spouse or civil partner was to benefit from the same exemption as an outright gift to the spouse or civil partner, it could only be overridden by or with the consent of that person, and had to be followed by outright gifts (or gifts under which the testator's children became absolutely entitled by the time they reached 18).

The proposed changes mean that more complex trusts will continue to benefit from the exemption at the outset, though, if the life interest is in fact followed by continuing trusts for adult beneficiaries, there will be an IHT charge when those continuing trusts take effect and the periodic charge regime will apply while they remain in place.

Trusts for children aged 18 to 25

The proposed amendments also address to some extent the concerns in relation to the requirement that children take assets outright at 18 if the trusts for their benefit while they are under age are not to suffer the periodic charge. The proposals provide that, where the age at which children take capital outright is no greater than 25, the periodic charge will not apply while they are under 18. However, it will apply for the (up to) seven year period while they are aged between 18 and 25. This could lead to a tax charge of up to 4.2% when the children become entitled to the property outright at age 25. It is also essential if this regime is to apply that the entitlement to capital is not postponed beyond 25: the proposed amendment will not help where, for example, a will provides for children to take capital at 30.

The changes apply both to trusts for a testator's children established by his will and to existing accumulation and maintenance trusts. Under the rules announced on Budget Day, the latter had to be modified prior to 6 April 2008 so that beneficiaries took outright at 18 if they were not to become immediately subject to the periodic charge regime; the proposed amendments give a little more flexibility in this area, but still leave such trusts in a much less attractive position than they were pre-Budget.

However, the proposed amendments will give testators a much greater range of choices in terms of the interests they create for their children than would have been the case had the Budget changes gone through unamended. The main options for consideration and their tax effects will be:

1. Outright gifts – unaffected by Budget changes.
2. Trusts (known as 'bereaved minors' trusts') under which children take outright at 18 – no periodic charges and no charges when children take property outright.
3. Trusts where children take capital at 25 – no periodic charges while children are under 18 and no charge if they actually become absolutely entitled at or under 18; periodic charges while children are between 18 and 25 and a charge when they become absolutely entitled at an age no greater than 25.
4. Life interests (which take effect on the testator's death) under which children are immediately entitled to income but need not take capital at any specified age – property forms part of children's estate in the same way as it would have done pre-Budget and there are no periodic charges or charges if children take property outright.
5. Full discretionary trusts with maximum flexibility as to when and how children benefit – periodic charges and charges when children take property outright, as under the pre-Budget regime.

The amendments also allow step-parents (but not grandparents or more distant family members, or friends) as well as parents to set up bereaved minors' trusts: it was hoped that more extensive changes would be made in this area particularly since, if grandchildren step into their parents' shoes under the intestacy rules, the trusts for their benefit can qualify as bereaved minors' trusts under the original proposals.

Disabled trusts

Further amendments allow settlors with a condition expected to lead to a disability to establish tax favoured disabled persons' trusts. The original proposals prevented taxpayers in the early stages of degenerative disease from being able to settle their assets for their own benefit without incurring a 20% charge when the assets were settled, periodic charges during the existence of the trust and charges when property vested in beneficiaries outright. Such individuals (unlike other taxpayers) will, if the amendments are enacted, now be able to provide for their assets to be managed for their benefit without adverse tax implications. They (and taxpayers who are already disabled) will also be able to create trusts which confer life interests on themselves (as an alternative to discretionary trusts which were already permitted). It should be noted, however, that the categories of present or expected disability which enable taxpayers to qualify under the favourable regime are very limited.

Existing life insurance trusts

The Government is making good on the statement made in the notes accompanying the Finance Bill that the payment of further premiums on life policies held by trusts in existence on Budget Day will not prevent the policy from qualifying for the transitional rules which apply to existing trusts.

Complex new rules have been proposed which are designed to ensure that, where a policy is held on trusts which qualified immediately prior to Budget Day as interests in possession or under the accumulation and maintenance regime, the continued payment of premiums will not give rise to any immediate charge to tax and varying the terms of the policy in accordance with options available under the policy immediately prior to Budget Day will equally not lead to the tax regime changing. Interest in possession trusts will also benefit from pre-Budget status even if the identity of the life tenant changes after 6 April 2008 (provided that any change occurs on the death of a life tenant). However, accumulation and maintenance trusts which hold insurance policies will, like all other accumulation and maintenance trusts, need to be reviewed prior to 6 April 2008 with a view to deciding whether to convert them to trusts in which the capital vests at 18 or 25 in order to obtain preferential treatment.

Post death variations

As mentioned in our previous Stop Presses, the Government indicated, when introducing the proposed changes on Budget Day, its intention that, where a testator died with a will which created trusts which were not in the most tax effective format, the trustees would be able to vary those trusts within the two years immediately following the testator's death and so achieve any tax result the testator could have achieved by will. The Government's initial drafting did not achieve this effect but the position has now been corrected.

Conclusion

This change (and the other changes summarised above) will, if enacted, mean that the concern that perhaps ten million wills would need amendment as a result of the Budget changes has largely fallen away. However there is no sign of movement by the Government in a number of other important areas including:

- The impact of new rules on settlements made in the context of marriage/civil partnership breakdowns.
- The very limited range of tax efficient options for lifetime provision for children
- The tax cost for settlors (other than the disabled or those expecting to become disabled) who wish to create settlements for their own benefit.

We will continue to liaise with other professionals to try to achieve further modifications to the new regime. The parliamentary process means that (unless any of the amendments already tabled by opposition MPs are accepted at committee stage on 13 and 15 June) the most likely time for further developments is early July during report stage.

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