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Stop Press - Restructuring trusts before next April's deadline

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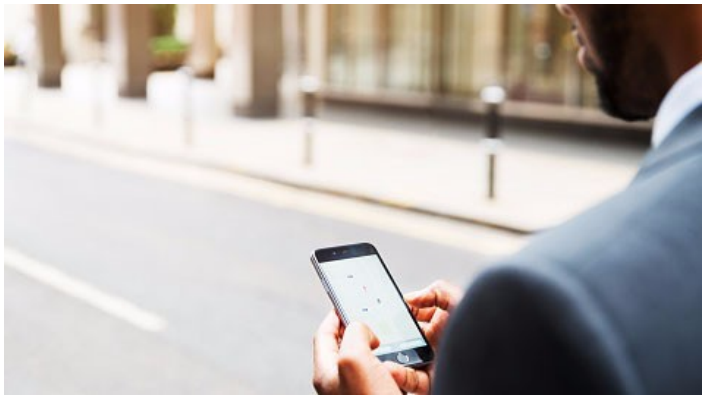

What's the rush?

As is generally known, a number of radical changes to the way in which trusts are taxed were announced in the March 2006 budget and later given statutory form in the Finance Act 2006. Unless action is taken in relation to many trusts by **5 April 2008** (or in some cases earlier), then such trusts will become subject to a potentially more unfavourable inheritance tax regime.

What trusts are affected?

The changes introduced by the Finance Act 2006 have had a fundamental impact on trusts with UK domiciled settlors or UK situate assets. The residence of the trustees and the proper law of the trust are not relevant so many 'offshore' trusts will be caught.

Since 22 March 2006, any new interest in possession settlement or accumulation and maintenance settlement is subject to the relevant property regime, with 10 yearly anniversary charges of 6% of the capital value and exit charges of up to 6% whenever capital leaves the settlement. Where settlements which were in existence on 21 March 2006 have had funds added since that date, the new rules will also apply.

From 6 April 2008, existing accumulation and maintenance settlements will also become subject to the relevant property regime unless advantage is taken of the options mentioned below. Interest in possession trusts which were in existence on 21 March 2006 will (subject to what is said below) become subject to the relevant property regime with effect from the death of the person who had an interest in possession on 21 March 2006.

Window of opportunity

The Finance Act 2006 includes a number of transitional provisions which must be utilised (if at all) before 6 April 2008.

The main such provision in relation to interest in possession settlements is the 'transitional serial interest' (**'TSI'**), a new life interest which (provided it comes into effect prior to 6 April 2008) will prevent the trust assets becoming subject to the relevant property regime until the death of the new life tenant (and then only if the assets continue to be held on ongoing trusts). The advantage of a TSI is that it enables assets to be pushed down to a younger generation before 6 April 2008, thereby keeping such assets out of the relevant property regime for the longest possible period of time. A TSI can also prolong the application of the old interest in possession regime if it takes effect on the death of the pre 22 March 2006 interest in possession beneficiary and is in favour of his spouse or civil partner. Such interests do not need to take effect before 6 April 2008 but it is sensible to consider now whether they should be put in place.

In relation to accumulation and maintenance settlements, there are two main transitional provisions. The first, the outright-at-18 trust, means that the settlement is altered so that the beneficiaries become entitled to the capital outright on or before age 18. If this is done, the trust fund will not become subject to the relevant property regime. The alternative approach is the 18-to-25 trust, whereby the settlement is altered so that the beneficiaries receive the right to capital at age 25. The trust fund is not subjected to any anniversary charges in such a situation but there is an exit charge of up to 4.2% when each beneficiary receives capital. The amount of flexibility available under the two regimes is different and the available options will also depend on the precise terms of the existing trusts.

It should also be noted that, if a beneficiary of an accumulation and maintenance trust will become entitled to receive an income interest between now and 6 April 2008, action needs to be taken before that interest arises as, if this is not done, the opportunity to avoid the full rigours of the relevant property regime will not be available.

Can trustees take advantage?

Now that the rules in the Finance Act 2006 have been clarified with HMRC, many trustees are considering what steps to take. However, the trustees' ability to amend any settlement so as to take advantage of the transitional provisions depends on the terms of the settlement deeds and whether or not there is the flexibility to introduce such changes. In most modern settlements this is not a problem, as they are drafted to be as flexible as possible, but a number of older settlements and will trusts do not have such flexibility.

Many trustees of English law trusts will take advantage of section 32 of the Trustee Act 1925 which enables trustees to advance up to half of a beneficiary's prospective capital share for his advancement or benefit. Although it is common to amend section 32 in the trust instrument so as to enable the trustees to apply all of a beneficiary's prospective share of capital, a number of older settlements do not have such a modification. Many trustees may therefore be faced with the situation that the main power they have relates to only 50% of the trust fund; if they were to act in relation to the other 50%, they would be in breach of trust. Trustees of trusts governed by another law will need to consider the extent to which any statutory provisions of their governing law assist them in this respect.

In some instances the trustees may be able to bring about changes to the settlement following the Finance Act 2006 by having all of the beneficiaries consent to a variation or by having a life tenant assign some or all of his life interest to another beneficiary. Problems arise where some of the beneficiaries are minors, not yet born or mentally incapable and therefore unable to consent or formally to assign their interests. Alternatively, some existing life interests are protected life interests and will automatically fall away if the beneficiaries try to assign them.

In any of the above circumstances it may be appropriate to make an application to the court for a variation to enable advantage to be taken of the transitional rules.

Even if trustees have wide enough powers to take advantage of the transitional provisions without applying to the court, they may be concerned that some beneficiaries will be dissatisfied. It is possible for the trustees to make an application to the court for directions and seek approval for their proposed course of action.

How can the court help?

Onshore

Under the Variation of Trusts Act 1958, it is possible for the beneficiaries (less commonly the trustees) to make an application to the court to vary a settlement if all the adult beneficiaries agree. This is useful if a trust cannot otherwise be varied because there are minors, unborn children or those who are mentally incapable who cannot themselves consent. If the court considers the variation to be for the benefit of all such beneficiaries (and benefit may be economic, tax driven, or for more social reasons) it will consent to the variation on behalf of those who cannot.

Offshore

All major offshore jurisdictions have legislative provisions in identical or similar form to the Variation of Trusts Act 1958.

How can we help?

Withers has considerable experience of drafting the types of documents which will be needed in the normal case where no assistance is needed from the court. We can also help with making applications to court for directions to trustees or to vary trusts in very tight time frames before unfavourable fiscal complications arise. There are likely to be numerous settlements which will require variation to enable changes to be made before 6 April 2008 (or earlier depending on the terms of the trust). Where an application to court is needed, it should be able to be heard on relatively short notice but it is expected to become more difficult to schedule a hearing date before 6 April 2008 unless action is taken shortly. Withers also has considerable experience in liaising with lawyers in other jurisdictions where an application to the Court may be required.

Conclusion

It is important for trustees, beneficiaries and their advisers to consider settlements in light of the changes introduced by the Finance Act 2006 and to take advice well before 5 April 2008. If a settlement does not provide the trustees with sufficient powers to make appropriate changes, then an application to court can be made to vary the settlement. Alternatively, if it is felt by the trustees that they would like approval for their proposed actions, they can ask for the court's blessing.

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