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Trusts, Inheritance Tax & Finance Act 2006  
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## **Trusts, Inheritance Tax & Finance Act 2006**

The Finance Act 2006 has introduced the most radical changes to the Inheritance Tax regime for trusts in thirty years. What is now law presents significant challenges for an individual's estate planning. The law is poorly drafted and is difficult to follow - Parliamentary scrutiny was perfunctory and Treasury notes accompanying the original draft Schedule and the amendments thereto would make Sir Humphrey Appleby proud of their Delphic character and economy. To make matters worse, and despite a two year period of consultation on trusts and the tax system, there was no consultation at all about the proposals for the new taxation of trusts for inheritance tax purposes for reasons that the Government now claim were to prevent forestalling.

The broad effect of the changes is to tax nearly all trusts under the general provisions that previously applied only to discretionary trusts - even though beneficiaries are entitled to the income of the trust or the trusts fall within the long established category of favoured trusts, in particular accumulation and maintenance trusts.

The new provisions have effect from 22 March 2006 and in simple terms make all new lifetime gifts into trust chargeable to inheritance tax as if they were discretionary trusts, that is at 20% on lifetime gifts in excess of the nil rate band, with periodic and exit charges, except where they are to favoured trusts being trusts for disabled persons. The definition of potentially exempt transfers (PET) has accordingly been substantially amended.

Amendments tabled in response to the widespread criticism of the original Finance Bill provisions apply to trusts established by wills, and in favour of beneficiaries under the age of 25 who have lost a parent; and to some extent relax the requirements for an interest in possession (“IIP”) to be eligible to be treated as an immediate post death interest, and also attempt to deal with the “spouse/civil partner” exemption. However there has been a significant divergence of views on the effect of the amendments. In light of this and the uncertainty caused by the new provisions this bulletin summarises the main features of the new law - no consideration is given to disabled trusts. It should not be taken as a substitute for professional advice on the specific circumstances of a particular client but is meant to help identify the choices that are now available. It is likely that significant changes to even basic estate planning will result from the new legislation.

## General

After 21 March 2006 only outright gifts to individuals, gifts to disabled trusts, and gifts to a bereaved minor’s trust on the coming to an end of an immediate post-death interest will qualify as PET’s as well as the payment of life insurance premiums on pre 22 March 2006 policies written in trust.

Treatment depends on:

- when the trust was established either before 22 March 2006 or not
- whether the trust was established during the settlor’s life or on death

- what interests existed at 22 March 2006
- precise terms of the trust

Life policies held in trust pre 22 March 2006 are covered by new sections 46A (IIP) and 46B (accumulation and maintenance) and enjoy transitional protection and section 49E provides for transitional serial interests.

New IIP concepts - immediate post-death interest section 49A IHTA 1984; transitional serial interests section 49B and disabled person interest section 89B. Persons having a beneficial entitlement to an IIP arising after 21 March 2006 are only treated as having an interest in the underlying property if they come within one of the three new categories above.

Accumulation and Maintenance trusts, which have enjoyed favoured IHT status since Capital Transfer Tax was introduced, governed by section 71 IHTA 1984 and settled before 22 March 2006 continue as before until 6 April 2008, when new provisions limit the section to property where the beneficiaries will take outright on or before becoming 18. Where trusts have been altered to cater for these changes section 71 will continue to apply, but not otherwise. Section 71 ceases to have effect for property settled after 21 March 2006. Where section 71 does not apply the trust assets become “relevant property” and the discretionary trust regime will apply with periodic and exit charges.

The current treatment of trusts which prior to 22 March 2006 were IIP trusts remains the same. If on the occasion when the IIP terminates someone then takes an absolute interest, this will be treated for Inheritance Tax purposes as a

transfer by the person who had the IIP: it will be either a transfer on death, or a PET, with the same Inheritance Tax consequences as before the Budget.

If, however, when the IIP terminates, the property remains settled property, then this will be treated as the creation of a new settlement. If the IIP terminates during the lifetime of the person entitled to income, the termination will be treated as a transfer creating relevant property, immediately chargeable at 20% (to the extent that the transferor's nil rate band has not been exhausted) and thereafter taxable under the discretionary trust regime. If the termination occurs on death, then the settled property will be taxed as part of the estate of the former life tenant, and thereafter the property will be taxed as relevant property under the discretionary trust regime. No spouse exemption will apply where a surviving spouse succeeds to such a life interest after 6 April 2008

## Wills

Outright gifts are unaffected.

New favoured trust - trust for bereaved minors under which a child who has at least one deceased parent may take, under a will or intestacy, capital and income at age 18 - no periodic charges and no charge when child takes outright. Only parents, not grandparents can give.

Trusts where children take capital at 25 - no periodic charges until child attains 18 and no charge if they take absolutely at 18. Between 18 and 25 there is a periodic charge and at age 25 a 4.2% exit charge.

Where existing wills provide for a nil rate band discretionary trust consideration needs to be given to the use of section 142 or section 144(as amended).

Provision for spouse (also includes civil partner) to be given life interest retains spouse exemption even where interest capable of being overridden by powers conferred on trustees or where interest followed by trust for other individuals (although there may be an IHT charge when the continuing trusts take effect and a periodic charge whilst they remain).

## Lifetime Gifts

Lifetime gifts into trust will be immediately chargeable at 20% on the excess over the nil rate band and periodic and exit charges will apply at up to 6% every 10 years, apart from disabled trusts.

Holdover relief for capital gains tax will generally apply on gifts into trust as there will be a chargeable transfer. However, the lifetime termination of a post 21 March 2006 life interest in possession will not be a transfer of value since under the new rules the life tenant does not own the property.

Under the law as enacted the lifetime transfer of assets to an interest in possession trust in favour of a spouse/civil partner does not attract spouse exemption yet is a capital gains tax disposal for which there is no holdover relief. As arrangements of this type have been common in divorce settlements care will need to be exercised.

What action needs to be taken now?

- Review existing wills and settlements to identify accumulation and maintenance trusts and consider amendment to satisfy new conditions. Identify nil rate band discretionary trusts, immediate post-death interests and transitional serial interests. Identify gifts into trust from grandparents to grandchildren
- Review lifetime settlements made since 22 March 2006 with life interests given to the spouse/civil partner.
- Review any post 21 March 2006 settlement connected with a divorce for additional costs under the new regime
- Review pre 22 March 2006 Accumulation and Maintenance trusts and subject to the terms of the trust consider appointments and advancements before 6 April 2008
- Identify terms under which life policies have been written in trust pre 22 March 2006
- When considering wills and settlements post FA 2006 consider outright gifts, availability of property with special reliefs eg business and agricultural property
- Despite Parliamentary assurance watch the spouse exemption.

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## Succession & Trusts @ 11 Stone Buildings

**Nigel Meares** specialises in traditional chancery work, including commercial and residential property drafting, and heavy commercial and property litigation arising mainly out of business acquisitions. His practice also encompasses disciplinary tribunals, financial services work, high-asset trust drafting and professional negligence. Recent cases of note have involved a large commercial property contract for a major house builder, deceit and breach of warranty claims, offshore trusts, asset-tracing, mortgage fraud and a major trial concerning local authority fraud and deception.



**Jonathan Arkush** conducts a wide range of commercial and chancery litigation, including contract, real property, company, insolvency and partnership. His practice also extends to estates and trusts including wills, family provision and probate. Clients vary from individuals to banks, building societies, PLCs and major retail operators. Jonathan is a qualified mediator and member of the mediation panels of the Property Bar Association, the Association of Contentious Trust and Probate Practitioners and Dispute Mediation Limited. He received the ADRg Award 2006 for his contribution to ADR and was cited as one of the group's most successful mediators. Jonathan is author of the chapter Landlord and Tenant Disputes in ADR and Commercial Disputes (Sweet & Maxwell). He is recommended as a leading junior in property litigation. He sits as a Deputy Master in the Chancery Division.



**Sidney Ross** is a specialist in chancery drafting and advisory work, he deals with trusts, wills and probate matters and administration of estates, matters concerning older clients, applications to the Court of Protection and estate planning. In particular he is very experienced in claims under the Inheritance Act, including cases which also involve claims to beneficial interests in the subject-matter of the deceased's estate or challenges to the validity of the deceased's will. He is the author of Inheritance Act Claims - Law and Practice (Sweet & Maxwell), the 2005 edition of which has been published for the first time in the Practitioner



series. He is also a regular contributor to legal journals on family provision matters and questions of will construction.

**Charles Holbech** specialises in all aspects of property, land and trust law, with a mix of litigious and advisory work and associated professional negligence claims. He has extensive experience in trust drafting, the use of trusts in tax planning and in matters relating to trust administration. His private client work also includes wills, probate, succession and claims relating to the estates of deceased persons, including the area of family provision. His property practice includes commercial, residential and agricultural landlord & tenant law, leasehold enfranchisement, conveyancing, mortgages and manorial rights.



**Marilyn Kennedy-McGregor** is known as a forceful advocate who specialises in commercial and real estate litigation, professional negligence, family provision, contested wills and inheritance claims. Within the field of trusts she specialises in contentious matters directly or incidentally involving trusts, such as commercial, family and property litigation in which resulting and constructive trusts arise as a matter of law, in particular those where negotiating and advocacy skills are essential. She also advises on the construction of trust deeds and the effects of all types of trusts in non-contentious matters. Her wills, probate and family provision work again emphasises contentious matters including



construing disputed wills, advising on evidence and strategy, negotiating the best settlement for the client and litigating the question in court.

**Douglas Keel** was called to the Bar in 1997, having previously been a tax partner with Price Waterhouse specialising in international tax planning. His practice now encompasses the whole range of UK direct and indirect taxation for companies and internationals. He can be of assistance with: minimizing tax liabilities; rationalizing complex arrangements; simplifying decision making; diagnostic health check – identifying hidden issues; the construction and interpretation of double taxation conventions; tax effective document drafting; transfer pricing theory and practice; disputes with and between Revenue authorities; management and control of offshore vehicles (tax residence); investment in overseas property and the funding thereof – advice on structuring UK property investment – any private client aspects to be handled in conjunction with the 11 Stone Buildings private client team; setting up of offshore companies in low tax jurisdictions in the light of anti-avoidance legislation; international asset protection and exploitation of intellectual property rights.



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