TAX PLANNING THROUGH TRUSTS AND WILLS

Highlights of Key Haven Publications PLC Conference, 15th June 2006

Speakers:

I Robert Venables QC ("Robert V")
II James Kessler QC ("James")
III Robert Argles ("Robert A")
IV Rory Mullan ("Rory")
V Amanda Hardy ("Amanda")

Reported by Ralph Ray[1]

I The IHT Treatment of Trusts and Settlements: The New Rules – Robert Venables QC

1 **The new law** does not necessarily apply with immediate effect to settlements already existing prior to 22 March 2006. The general principle is that new law will apply except to the extent that the transitional provisions contained in the Finance Bill are operative. Note that no changes are made to the discretionary trust regime – merely that the net that catches these trusts is considerably wider.

2 **Recognised Interest in Possession and Unrecognised Interests in Possession**

This terminology is Robert's. If the drafter had used it, it would have saved a lot of space. Broadly speaking a recognised interest in possession

1 Ralph Ray, Solicitor (CTA (Fellow), TEP, B.Sc(Econ) tax consultant with Wilsons of Salisbury (www.wilsonslaw.com)

is one which is treated the same way as before the 2006 Budget Speech and an unrecognised interest in possession is one which is now ignored for inheritance tax purposes.

In general terms, a recognised interest in possession will be the only type of interest in possession which is recognised for capital gains tax purposes (especially the tax-free uplift in the trustees' base cost of the settled property on the death of the beneficiary). Certain persons were – and still are – deemed to have an interest in possession for inheritance tax purposes but not for capital gains tax purposes. Even if they now have a recognised interest in possession, the capital gains tax position is unchanged.

Recognised Interests in Possessions: New interests in possession, i.e. those to which a person becomes beneficially entitled after 21st March 2006 will be Recognised Interests in Possession only if they fall into one of three categories:

(a) immediate post-death interest;

(b) disabled person's interests; and

(c) transitional serial interest.

An immediate post-death interest (as defined in s.49A and see below) can be created indefinitely and will be of some use. So can a disabled person's interest, but will be of limited use. No transitional serial interest can be created after 5th April 2008 or in property which becomes settled only after 21st March 2006.

Since the 8th June amendments, this is now much more straightforward.

For example, if one spouse leaves a life interest to the other, the widow(er)'s life interest should in all circumstances constitute a recognised interest in possession. Provided the widow(er) is domiciled in the UK, the deceased should make an exempt transfer of value.

The spouse's interest can now be revocable **without her consent**. If it is revoked during her life, she will be deemed to make a transfer of value (which may be subject to a potentially exempt transfer of value).

Broadly speaking, therefore, an interest in possession (a) created by a new *inter vivos* settlement or (b) to which a beneficiary becomes beneficially entitled after 5th April 2008, will not be a recognised interest in possession.

Taxation of Beneficiary on Death of Beneficiary

Under the **old law**, on the death of an individual beneficially entitled for an interest in possession, the settled property normally formed part of his estate on death and was thus normally subject to inheritance tax by virtue of Inheritance Tax Act ss.49(1) and 5(1). However, as s.49(1) does not apply to an **unrecognised interest in possession**, on the death of a person entitled for an unrecognised interest in possession, the settled property itself will not be brought into charge to tax.

Taxation during the lifetime of the Beneficiary

Under the **old law**, if the person entitled to a recognised interest in possession disposed of it during his lifetime or the interest came to an end before his death, the general rule was that he was deemed to make a transfer of value, the value transferred being the value of the corresponding underlying settled property: see the unamended Inheritance Tax Act ss.51 and 52.

The New Law: Unrecognised Interest in Possession

Under the new law, ss.51 and 52 no longer apply to an unrecognised interest in possession, the termination or disposal of which *inter vivos* gives rise to no inheritance tax consequence, except possibly a gift with reservation charge.

The New Law: Recognised Interests in Possession

One would expect that, under the new law, a recognised interest in possession would be treated in just the same way as all interests in possession were under the old law and that there would be no discrimination between the tax treatment of the termination of an interest in possession and its disposal.

Disposal of Recognised Interests in Possession

However, the Inheritance Tax Act 1984 s.51 (disposal of interest in possession) as amended provides:

"(1A) Where the interest disposed of is one to which the person became beneficially entitled on or after 22nd March 2006, subsection (1) above applies in relation to the **disposal** only if the interest is -

(a) an immediate post-death interest, or

(b) a transitional serial interest.

(1B) Where the interest disposed of is one to which the person became beneficially entitled before 22nd March 2006, subsection (1) above does not apply in relation to the disposal if, immediately before the disposal, s.71A or 71D below applies to the property in which the interest subsists."

Hence, settled property in which an **unrecognised interest in possession** subsists will normally be "**relevant property**", and as such **Interests in Possession do not form Part of a Person's Estate.**

Reversionary Interests: the law relating to these interests has not been altered.

3 Settlor Takes Initial Interest in Possession

Under the old law, the making of the settlement involved no transfer of value as the settlor was deemed to own the property he had settled.

Under the new law, the unrecognised interest in possession does not form part of the settlor's estate. He will prima facie make a **transfer of value** and the value transferred will normally be at least equal the value of the property settled!

Periodic Charges and Exit Charges on Settled Property

No relief when the person entitled to an unrecognised interest in possession becomes absolutely entitled to the settled property.

4 Accumulation and Maintenance Trusts

Robert referred to an accumulation and maintenance trust as a "**qualifying accumulation and maintenance trust"** if, under the rules in force before 22 March 2006, it would have qualified under Inheritance Tax Act 1984 s.71(1) for special treatment for inheritance tax purposes – in particular the exemption of the settled property from the periodic and normal exit charges to inheritance tax – notwithstanding that, on account of the "twenty-five year rule", contained in s.71(2), it might at some time in the future have ceased to qualify whilst remaining an accumulation and maintenance trust.

Robert referred to an accumulation and maintenance trusts as a "**recognised accumulation and maintenance trust**" if and for so long as (being a qualifying accumulation and maintenance trust), it qualifies under the new rules which came into force as at 22 March 2006, for such special treatment for inheritance tax purposes, notwithstanding that it might at some time in the future, while remaining a (qualifying) accumulation and maintenance trust, cease to qualify for such special treatment whilst remaining a (qualifying) accumulation and maintenance trust.

Existing Qualifying Accumulation and Maintenance Trusts

Existing qualifying accumulation and maintenance trusts will cease to receive special treatment as accumulation and maintenance trusts at the **end of 5th April 2008**, even though they are still qualifying accumulation and maintenance trusts, unless either (a) they satisfy new stringent conditions, or (b) they fall within Inheritance Tax Act 1984 s.71A (trusts for bereaved minors). In fact, a trust which fails to meet the new stringent conditions will also fail to satisfy the conditions necessary for it to fall within s.71A.

New Qualifying Accumulation and Maintenance Trusts

A "new" qualifying accumulation and maintenance trust, i.e. one which becomes a qualifying accumulation and maintenance trust for the first time after 21st March 2006, will not qualify for the special treatment accorded to accumulation and maintenance trusts unless it falls within Inheritance Tax Act 1984 s.71A (trusts for bereaved minors). Such new A&M trusts are in effect defunct. This is the case even if the settlement in question was created before that date and the trust came to be a qualifying accumulation and maintenance trust automatically e.g. on the death of a tenant for life.

The New Conditions for Existing Qualifying Accumulation and Maintenance Trusts

An accumulation and maintenance trust which was already a qualifying accumulation and maintenance trust immediately before 22nd March 2006 will, so long as it continues to be a qualifying accumulation and maintenance trust, be a recognised accumulation and maintenance trust until the end of 5th April 2008. Thereafter, it will be an unrecognised accumulation and maintenance trust unless it satisfies further conditions or unless it falls within s.71A (trust for bereaved minors). The further conditions are that one or more person will, on or before attaining a specified age not exceeding *eighteen* (i.e. not twenty-five), become

beneficially entitled to *the settled property itself*. See s.71(1) as amended. Note the Committee Stage amendments for "age 18 to 25" trusts. Subject to strict conditions, the 6% ten yearly relevant property charge becomes 4.2%, i.e. a proportion from age 18 to 25 (= 7/10 of 6%).

5 Capital Gains Tax Effects

Gift to An Interest in Possession Trust where the Interest in Possession is an Unrecognised Interest in Possession: Prima Facie the Settlor is deemed to receive a Market-Value Consideration. See Taxation of Chargeable Gains Act 1992 ss.17 and 18.

Holdover Relief

Taxation of Chargeable Gains Act 1992 s.**260** (Gifts on which inheritance tax is chargeable etc) should be available.

II Alternatives to Settlements – James Kessler QC

James examined a number of **alternative strategies** which promise to give some or all of the practical advantages of settlements without creating a "settlement" exposed to the new inheritance tax rules.

1. Uses of Bare Trusts

Bare trusts may be used in two cases: (1) A settlor may make a gift to a bare trust rather than a substantive trust. (2) Existing Accumulation and Maintenance ("A&M") trusts may be converted into bare trusts (before 2008) to avoid ten-year charges.

Tax Advantages

A bare trust is not a "settlement" for IHT purposes and so is outside the standard Inheritance Tax ("IHT") regime. A gift to a bare trust is a Potentially Exempt Transfer ("PET"). The trust fund is in the estate of the beneficiaries. If a sole beneficiary attains 18, he can call for the fund to be transferred to him. If a joint beneficiary attains 18, he can call for his share of the trust fund to be transferred to him **if it is easily divisible –**

see *Crowe v Appleby* 51 TC 457. However, the beneficiary may agree not to call for the property to be transferred to him (subject to receiving independent advice). On attaining the age of 18, a beneficiary may be invited to sign an agreement along the following lines:

> "*Dear [trustees]*
>
> *In return for your continuing to act as trustees, I agree not to call for my share of the [name of trust] bare trust to be transferred to me until I reach the age of 21, or I have given the trustees one month's notice in writing, whichever shall be the later.*
>
> *Signed……………"*

Power of advancement

A bare trust may contain a power of advancement. This allows the trustees to apply capital of each beneficiary's share for the benefit of the beneficiary. It would authorise the trustees to transfer the beneficiary's share to a new, substantive trust, if this is for the benefit of the beneficiary – *CD v O* [2004] EWHC 1036. This can be done at any time, if there are good reasons why it would benefit the beneficiary to transfer the funds to a substantive trust under which he could not spend the capital. This would include situations where: a beneficiary is about to become bankrupt; a beneficiary is about to divorce; or a beneficiary is about to die.

2. Interest-free Loans

A parent may be prepared to make an interest-free loan to a child, thereby in effect gifting the income and gains which the money lent would otherwise have generated. At first sight, this looks like a relatively painless and convenient way of giving. As the lender ceases to have any income from the money lent, he in effect obtains tax relief at all rates on the income and gains forgone. Moreover, if the loan is repayable on demand, or at short notice, his commitment may be terminated at any time.

Income tax liability of the lender

Settlement provisions – one cause for concern is the income tax settlement provisions, Chapter 5 Part 5 ITTOIA. An interest-free loan can clearly be a "settlement". See *Levy v IRC* 56 TC 68. This is confirmed by s.620(1)

ITTOIA which provides that "settlement" does not include a charitable loan arrangement.

3. **Deferred Shares**

Basic Deferred Shares – (James's terminology) provide: (1) No rights for a fixed period (say, 30 years); (2) Substantial rights thereafter (say, ranking equally with all other shares ("ordinary shares").

Deferred shares may be created by: (1) the reorganisation of existing shares, or (2) the issue of deferred shares. This is in principle a reorganisation with no tax consequences. As to IHT consequences: the ordinary shares will be retained by the existing shareholder(s); and would not pass to the deferred shareholder(s). Refer to IHTA s.98.

III Tax Planning for Foreign Domiciliaries and Excluded Property after the 2006 Finance Act – Robert Argles

1. The effect of Finance Bill 2006 clause 158 [now Finance Act 2006 s.157] is to frustrate the saving of tax achieved by the **purchase** of excluded property, by providing that where the interest in possession is purchased property comprised in the settlement which might otherwise come within IHTA s.48(3) or (3A), will cease to qualify as "excluded property". So in these most obvious of cases relief will no longer be available.

The provisions operate only where the interest in possession was purchased under a bargain made on or after 5th December 2005. If the interest in possession was purchased before that time the UK domiciled purchaser will continue to enjoy the benefit of the exemption conferred on the excluded property trust by s.48(3).

The changes bring beneficial entitlements to interests in possession in line with the rules relating to reversionary interests in s.48(1). Under these a reversionary interest is "excluded property" unless it was acquired for a consideration in money or money's worth. The object in each case is to frustrate the avoidance by the substitution for property which does not qualify for relief as excluded property with property which does.

A large number of "excluded property trusts" continue to qualify for relief. In particular the excluded property trust is likely to remain a firm favourite with the increasing numbers of non-domiciliaries who are contemplating taking up a residence in the UK and who are unlikely to be in any way affected by the change.

IV Wills and Deeds of Variation after Finance Act 2006 – Rory Mullan

1. In order that a person will have an immediate post-death interest in possession at any given time, then:

   (1) they must be beneficially entitled to an interest in possession in settled property;

   (2) the disposition whereby that settled property became held subject to the interest must be effected by Will or under the law relating to intestacy (Condition 2 and s.43(2) IHTA 1984);

   (3) the beneficiary must become beneficially entitled to the interest in possession on the death of the testator (the administration period and survivorship clauses for periods under 6 months are ignored for this purpose: ss.91 and 92 IHTA 1984);

   (4) the trust is not and never has been a trust for a bereaved minor;

   (5) the beneficiary is not and has not, since the creation of the interest, been a disabled person within s.89(4) to (6).

   It can be seen that (following amendments made on 8 June) provided the beneficiary is neither (i) a bereaved minor or (ii) a disabled person, then every interest in possession, the trusts of which are created by Will, will give rise to a favoured immediate post-death interest in possession and not within the "relevant property" regime.

2. **Deeds of Variation for persons who died before 22nd March 2006**

   Although the changes introduced in Schedule 20 to FB 2006 substantially reduce the circumstances in which a person can make or is deemed to make a potentially exempt transfer after 22nd March 2006, property can still be transferred into settlement, or transfers of value arranged under the 'old' inheritance tax rules in relation to property which formed part of the estate of a deceased person who died within the last 2 years *but* before 22 March 2006 – see IHTA s.142(1).

Provided that any variation of the dispositions of the deceased's estate can properly be made and conforms to all the other requirements of s.142, then it will be deemed to take effect upon the death of the Deceased. If that is before 22nd March 2006, it will be treated as made under the law as it applied before the introduction of Schedule 20.

3. Other Will Trusts attracting Favourable Treatment

Two other categories of trust which are created by Will attract a favourable inheritance tax treatment. These are trusts for bereaved minors, and the somewhat confusingly named trusts for 18 to 25 year olds. The benefit of these trusts and immediate post-death interests in possession is that property in them is not relevant property for the purposes of IHTA s.58.

4. Administration of Nil Rate Band Trusts

One of the very few advantages of the new inheritance tax regime for interest in possession trusts (as originally drafted) was that where it was sought to transfer property by Will but outside a beneficiary's estate (for example cases where there is significant business or agricultural property qualifying for 100% relief or indeed where it is sought to preserve the testator's nil rate band), the benefit of the relief could be preserved for the benefit of a widow or widower (by creating an interest in possession for his or her benefit) without having to rely on the discretion of the chosen trustees.

A further benefit was that arguments as to the creation of an interest in possession through use of trust property, namely that by allowing a discretionary beneficiary to live in trust property, the trustees are giving him an interest in possession in that trust property (see for example Statement of Practice 10/79 *Power for trustees to allow a beneficiary to occupy a dwelling house*) would no longer be relevant (although see *Judge v HMRC* (SpC 506) in any event). This should have enabled a more straightforward administration of trust property.

In particular, where a nil rate band trust has been created it is much simpler to appropriate a share of the family home to the nil rate band trust rather than entering into debt scheme (which HMRC argue gives rise to an SDLT liability), or the charge scheme, which has practical disadvantages insofar as it is sought to move home.

V Tax Planning for the Family Home Implications of the Finance Bill 2006 – Amanda

1. Action that should be taken, if not immediately, after Finance Act receives Royal Assent, is a review of existing arrangements involving the family home to see whether the changes to inheritance tax and capital gains tax in relation to A&M trusts and interest in possession trusts affect the arrangements and whether further steps can be taken to avoid any problems.

2. **Checklist for arrangements involving interest in possession trusts**

   (1) Should we wait for a future government to repeal the changes, political crystal ball necessary. However, if there is an interest in possession within the transitional rules which is likely to last for a substantial period, may be worth considering. An interest in possession will be within these rules and will, broadly, continue to be taxed according to the pre-Finance Act 2006 regime if:

   (i) the person beneficially entitled to the interest in possession was entitled prior to 22 March 2006, or

   (ii) it is a transitional serial interest, or

   (iii) it is a disabled person's interest.

   (2) If action is taken during the transitional period to bring an interest in possession to an end (either on termination or disposal) there is not charge to inheritance tax in certain circumstances and it remains a PET in other circumstances. The preliminary question must always be, however, is it appropriate to bring the existing trusts to an end? What are the circumstances of the beneficiaries, including of course, the life tenant? Is it appropriate to allow absolute entitlement to avoid the tax charge? What about the other beneficiaries? Important not to let the tax tail wag the practical/trust dog.

   (3) There is no charge to inheritance tax on the termination or disposal of an interest in possession within the transitional rules if one of the following become absolutely entitled to the settled property or to an interest in possession which is a transitional serial interest:-

(i) the life tenant;

(ii) his/her UK domiciled spouse;

(iii) the settlor;

(iv) the settlor's spouse, or

(v) the settlor's widow/widower within 2 years of the settlor's death.

(4) There is also no charge if the trust was a s.71A trust (bereaved minors) before the transfer.

(5) There is also no charge if the settled property is excluded property.

(6) There is a potentially exempt transfer if:

(i) the life tenant is alive

(ii) an individual becomes absolutely entitled

(iii) an individual becomes entitled to a transitional serial interest

(iv) a disabled trust is created or benefited

(v) where an immediate post-death interest terminates, if a s.71A trust is created or benefited.

(7) Otherwise there is a chargeable transfer on the termination or disposal of the interest in possession unless there is a disposal for consideration within s.52(2) of IHTA 1984.

(8) Where there is a charge and the property continues to be settled property it will usually become relevant property within the discretionary trust regime.

(9) Capital gains tax considerations: Is there a charge on the termination or disposal of interest? Note there is the loss of the tax-free uplift on death where there is the termination of an interest in possession within the transitional rules.

(10) In addition, even where an individual is beneficially entitled to an interest in possession, but continues under the old rules as being treated as if he were entitled to the underlying property, a termination of the interest in the individual's lifetime on or after 22 March 2006 will be treated as a gift for the purposes of the gifts with reservation of benefit rules in s.102 of and Schedule 20 to the Finance Act 1986.

New Arrangements – Planning for the Future

Arrangements involving settlements – Note the following possibilities:

(1) As a result of the 9th June amendments, an interest in possession given to a surviving spouse which is an immediate post-death interest will attract spouse exemption.

(2) Continued utilisation of nil rate band discretionary trusts provisions with debt and charge arrangements for modest estates on death?

(3) A discretionary trust every 7 years, utilisation of normal expenditure out of income to fund pilot trusts or to pay insurance premiums.

VI Sophisticated Tax Planning for Trusts, New and Existing – Robert Venables QC

1. Avoid chargeable transfers of value in the previous 7 years.

2. Vanilla Planning: a discretionary trust every 7 years

3. Settle assets likely to appreciate in value – e.g. reversionary interests, shares in start up companies, deferred shares

4. Use of the normal expenditure out of income exemption to fund pilot trusts

5. Use of excluded property rules: settling of reversionary interest on discretionary trusts? But bear in mind IHTA 1984 ss.81 and 80

6. Use of IHTA 1984 s.142. See further Rory Mullan's Talk.

7. Nil Rate Band Testamentary Trusts – accept that the transfer to the trust may well be a chargeable transfer. Set up pilot trusts and make additions to Wills.

8. Use of Employee Trusts: Non-Relevant Property Trusts
Trusts can easily be contrived which fall within IHTA 1984 s.86 and outside the new s.58(1A) and are thus not relevant property trusts under which only family members are likely to benefit, notwithstanding a wide class of discretionary beneficiaries. It should normally be possible to avoid any inheritance tax under IHTA 1984 s.72 when capital is appointed out and, if care is taken, any charge to income tax as employment income. Consider, however, the effect of the *Dextra* decision HL (2005) 77 TC 146.