NOTES ON KHP CONFERENCE

reported by

Ralph Ray[1]

TAX PLANNING THROUGH TRUSTS
Wednesday, 23rd May 2007

Speakers:
Timothy Lyons QC and Chair
Amanda Hardy
Rory Mullan

1. Some Recent Developments – Timothy Lyons QC ("Timothy")

Trusts for minors

Timothy referred to the debate on whether or not an absolute trust for a minor (i.e. a bare trust) is a settlement for the purposes of IHTA 1984 s.43(2). HMRC suggested in December 2006 that it may be due to the Trustee Act 1925 s.31 (with its power to accumulate income during minority). If it were to be so regarded a gift to a minor would not be a PET. However, HMRC's letter of 23 March 2007 states that it takes the view that: "*… an absolute trust for a minor is not a settlement for IHT purposes. It follows, therefore, that a lifetime gift on trust for a minor absolutely will be, in our view, a potentially exempt transfer"*. The general understanding of this statement is that s.31 does not need to be expressly excluded. Timothy, however, recommends such specific exclusion; and advises against **express** powers of accumulation.

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***Jasmine Trustees and Ors v Wells & Hind (a firm) and anr* [2007] STC 660**

On the appointment of new trustees, there was no discharge of pre-existing trustees by virtue of the Trustee Act 1925 s. 37(1)(c) in the form which it took prior to amendment by the Trusts of Land and Appointment of Trustees Act 1996. (This gives a discharge where there will be either a trust corporation or at least two *persons* to act as trustees to perform the trust. Previously the reference was to *individuals*. Now the reference is to *persons*.) The non-discharged individuals remained trustees but did not participate in subsequent appointments of trustees. These were accordingly invalid and those "appointed" were trustees de son tort. Were these trustees de son tort trustees of the settlement for CGT purposes (TCGA 1992 s.69)? Held: No. Consequently, it was not the case that a majority of the trustees for the time being were non-UK resident or ordinarily resident. Furthermore, the appointments of property were carried out by the wrong people and certain trustees' resolutions were therefore invalid.

***Foulser v MacDougall* [2007] EWCA Civ 8**

It is well accepted that exit charges are contrary to EC law, particularly so far as concerns individuals. There are good grounds also for considering that they are contrary to EC law in relation to companies. This was insufficient to assist the Foulsers who challenged the limitations on holdover relief in TCGA 1992 s.167: no relief is available where the company concerned is controlled by a non-resident connected with the disponor. They failed because the Court of Appeal held that there was a connection with the disponor.

2. The Inheritance Tax Alignment Regime: Will Trusts and Variations of Deceased's Estates – Amanda Hardy ("Amanda")

Introduction

The Finance Act 2006 made unexpected changes to the inheritance tax treatment of trusts. Until the Budget 2006 proposals, the principle of tax policy was stated to be that: *"the government recognises the important role trusts play in society and has said that as far as possible it wants a tax system for trusts that does not provide artificial incentives to set up a trust, but equally avoids artificial obstacles to the use of trusts where their use would bring significant non-tax benefits*". As a result of the unexpected restriction on the type of lifetime transfers qualifying as potentially exempt transfers (PETs), a lifetime gift to another individual, at present, remains a PET but a gift to a trust (other than to a disabled trust) is generally chargeable.

Will trusts where the testator died before 22nd March 2006

Trusts may have been established by the will of a person who died before 22 March 2006. In general, the Finance Act 2006 provisions affect will trusts in much the same way as existing *inter vivos* trusts. However, if a person died less than two years before 22 March 2006 and s.144 IHTA 1984 (distribution from property settled by will) applies, the amendments to that section need to be considered.

There will broadly be three situations where trusts created under the terms of someone's will after 22 March 2006 will be outside the relevant property regime. These are where the testamentary trust is:

(1) a trust for a bereaved minor within s.71A IHTA 1984; or

(2) an 'age 18 to 25' trust within s.71D IHTA 1984; or

(3) an interest in possession trust that is an immediate post death interest.

Amanda emphasised a number of important points. First, a bereaved minor can be given an interest in possession in the trust (i.e. be entitled to all the income) and the trust will still qualify. Secondly, only will trusts arising on the death of a bereaved minor's parent will qualify. Thus, trusts created under the will of a deceased grandparent in favour of a grandchild whose parents predeceased the grandparent will not generally qualify even if all the other conditions are met. However, the trusts to which s.71A applies need not take effect immediately on the death of the testator. Thirdly, the inclusion of a statutory power of advancement (e.g. under s.32 of the Trustee Act 1925) or "the trustees having powers to the like effect" of s.32 in a trust will not, of itself, cause the qualifying conditions to be breached.

If a trust qualifies as a trust for a bereaved minor it will be exempt from the discretionary trust regime and the assets of the trust will also not be treated as part of the bereaved minor's estate (whether or not he or she has an interest in possession in it).

There will be no charge to tax when a bereaved minor acquires an absolute interest in the trust assets on or before the age of 18 and capital gains tax 'holdover' relief is potentially available (in the same way that it can be available under the old rules when the beneficiary of an accumulation and maintenance trust takes an absolute interest).

Where a bereaved minor does have an interest in possession, there will be a capital gains tax uplift available to the trustees if the bereaved minor dies before attaining the age of 18.

Age 18-25 trusts

An age 18-25 trust under s.71D IHTA 1984 is a trust subject to various conditions and where the property is held for the benefit of a person who has not yet attained 25 where at least one of the person's parents has died and the trust is established under the will of a deceased parent of the under 25 year old or under the Criminal Injuries Compensation Scheme. Despite the short title "age 18-25 trusts" the beneficiary of such a trust need not be aged between 18 and 25 but must be below 25. As with trusts for a bereaved minor, trusts to which s.71D applies need not take effect immediately upon the death of the testator.

Amanda considered whether the exercise of the permitted powers can create new trusts for the benefit of a wider class of beneficiaries: *Pilkington v IRC* [1962] AC 612. If so, such 18-25 trusts are in fact much more flexible than first appears to be the case. Can it be said that it is likely to be for the benefit of almost any 18 year old to apply trust property by way of deferring an absolute interest, see: *"It is not in our judgment generally in the interests of young persons to come into possession of large sums of money which might discourage them from achieving qualifications and from leading settled and industrious lives to the benefit of themselves and the community*". – *Re Elizabeth K Gates Estate Trust* [2003] 3 ITELR 113.

Immediate post-death interests

By virtue of s.49A IHTA 1984, an immediate post-death interest arises where:

(1) a person ("L") is beneficially entitled to an interest in possession in settled property; and

(2) the settlement was effected by will or under the law relating to intestacy; and

(3) L became beneficially entitled to the interest in possession on the death of the testator or intestate; and

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

(5) the interest is not a disabled person's interest.

If a will trust qualifies as an immediate post-death interest, it will otherwise be treated in the same way as a pre 22 March 2006 interest in possession, that is, with any termination amounting to a transfer of value by the life tenant and with a capital gains tax 'uplift' available to the trustees. If it does not, the trust will be treated like any other new post 22 March interest in possession trust, that is, within the relevant property regime and without those other consequences previously associated with interest in possession trusts.

The single most important consequence of a trust qualifying as an immediate post-death interest is that where the initial life interest is in favour of the testator's spouse or civil partner, the gift to the trust will qualify for the spouse exemption and the assets will form part of his or her estate. Conversely, if a trust does not so qualify, the gift will not qualify for the spouse exemption, but neither will the trust assets form part of the spouse's or civil partner's estate.

What to do with existing wills and will precedents

A review will have to be undertaken of current wills and will precedents to ascertain which include old style accumulation and maintenance trusts which will become defunct after 2008 and whether amendment is preferable. Consideration should be given to replacing such precedents with discretionary trusts or, age 18-25 trusts where appropriate. Consideration also needs to be given to income tax and capital gains tax consequences of new drafts.

In addition, consideration will need to be given as to whether an interest in possession should be an immediate post death interest or not and how to draft each alternative. For example, when wills are being prepared for married couples or civil partners, a view will need to be taken as to which of these alternatives is to be preferred. Where the estate of the deceased is in excess of the nil rate band, it will clearly be important to ensure that spouse exemption is available and it will be necessary to ensure that an immediate post death interest is created. Where the estate is small, however, the drafters may prefer to keep the assets of the new trust outside the spouse's or civil partner's estate to avoid aggregation on the second death. To this extent, 'non-qualifying' interests in possession for surviving spouses may replace nil rate band discretionary trusts as the simplest way of ensuring that the nil rate band is utilised on the first death. Consideration should be given to the advantages flowing from having an "unrecognised" interest in possession in relation to the family home and capital gains tax main residence relief.

Deeds of variation – Section 142 IHTA 1984

Section 142 IHTA 1984 permits, subject to certain restrictions, any of the dispositions of the property comprised in the estate of a person immediately before his death to be varied within the period of two years after the death and for the persons effecting the variation to ensure that the inheritance tax legislation shall apply as if the variation had been effected by the deceased. Section 142 was not amended by FA 2006. Therefore, if the deceased died prior to 22 March 2006, a variation which complies with all the conditions of s.142 IHTA 1984 can be treated as made under the old law as it applied before the FA 2006 changes.

Section 144 IHTA 1984

Section 144 IHTA 1984 broadly seeks to ensure that, if property is settled by will and is relevant property, then if an event occurs within two years of the death and it ceases to be relevant property there is no exit charge and the estate is treated on the testator's death as if the will had provided that the property was held as redirected. While FA 2006 does not seek to disturb the principle behind s.144, certain amendments were necessary to ensure that it works as it did before. For example, if a discretionary trust was created by will and within two years of death the trustees appoint an interest in possession to the widow, post FA 2006, that would be an unrecognised interest in possession and the property would not cease to be relevant property as is necessary for the operation of s.144. Therefore, s.144(1) IHTA 1984 now corrects and remedies the situation.

The trustees should therefore consider the most appropriate alternatives in exercise of their powers under s.144 as amended, for example, an appointment to a surviving spouse of an interest in possession that qualifies as an immediate post death interest to obtain inheritance tax relief on the testator's death, s.71A or 71D trusts, absolute appointments or non-relevant property employee trusts.

Who is the Settlor?

Prior to FA 2006, question of who was the settlor created by a variation within s.62(6) TCGA 1992 was fascinating. The House of Lords in *Marshall v Kerr* [1994] STC 638 established that where the estate was governed by English law and what was settled was an absolute interest in residue effected during the period of administration, then the settlor for capital gains tax purposes was the residuary legatee and not the testator. However, where the estate was fully administered before the variation or the estate was governed by foreign law or what was settled was not an interest in residue, the position could, in Amanda's view, be different and the testator treated as settlor. Accordingly, s.68C appears to widen the scope of *Marshall v Kerr* to all cases where a person absolutely entitled to non settled property comprised in an estate enters into a s.62(6) TCGA 1992 variation that creates a settlement.

Where the property is already settled, however, then the intention is that if the property becomes comprised in another settlement it is the testator who is treated as the settlor.

3. Tax Mitigation and Trusts: A Miscellany – Timothy Lyons QC

***Phizackerley* SP00591, 14.2.07**

Mrs P left her estate on nil rate band trusts for Mr P and her children and remoter issue. Residue for the deceased absolutely. Mrs P's half share of the house was assented to Mr P on his promise to pay £150K to the trustees of the nil rate band discretionary trust. HMRC said the debt was not deductible by virtue of FA 1986 s.103. This provides for an abatement of a liability where consideration given for the debt consists of property derived from the deceased. The Special Commissioner found these conditions clearly satisfied as Mrs P's half share of the house, the consideration for Mr P's debt was property derived from Mr P. Moreover, the disposition was held not to be outside the transfer of value provisions by virtue of IHTA 1984 s.11 – maintenance of the family provision did not apply. This decision is unlikely to strike at the heart of this kind of planning (the charge scheme, using an equitable charge, would avoid the problem).

Discounted Gift Schemes ("DGS")

A DGS involves a gift of a bond to trustees of an absolute or discretionary trust from which rights to subsequent withdrawals are retained. The donor is excluded from benefit under the trust. There is in these circumstances no GWR. The donor has made a transfer of value of the bond less the value of the retained rights. What is the value of the retained rights? It depends upon the donor's age, health etc. Note the dangers of employing these arrangements in relation to very elderly individuals. More generally, HMRC note that if the settlor were to be uninsurable, the value of the retained rights would be very small.

Joint settlors: difficulties arise where there are significant age differences between settlors. A pragmatic approach (dividing value transferred equally) is impossible. HMRC set out their approach for all transfers after 1 June 1007 and before that date where the pragmatic approach provides an unreasonable solution. HMRC will apportion the value transferred according to the respective values of the retained rights.

Trusts for benefit of employees

IHTA 1984 s.86(1) says:

> "(1) Where settled property is held on trusts which, either indefinitely or until the end of a period (whether defined by a date or in some other way) do not permit any of the settled property to be applied otherwise than for the benefit of –
>
> (a) persons of a class defined by reference to employment in a particular trade or profession, or employment by, or office with, a body carrying on a trade, profession or undertaking, or
>
> (b) persons of a class defined by reference to marriage [to or civil partnership with] or relationship to, or dependence on, persons of a class defined as mentioned in paragraph (a) above,
>
> then, subject to subsection (3) below, this section applies to that settled property or, as the case may be, applies to it during that period."

The scope for the operation of trusts within s.86 can be very wide. Note in particular subsection (3).

If these statutory provisions are satisfied, the settled property is not "relevant property".

Excluded property trusts

It is well known that IHTA 1984 s.48(3) states:

> "Where property comprised in a settlement is situated outside the United Kingdom –
>
> (a) the property (but not a reversionary interest in the property) is excluded property unless the settlor was domiciled in the United Kingdom at the time the settlement was made, and

(b) s.6(1) above applies to a reversionary interest in the property but does not otherwise apply in relation to the property; but this subsection is subject to subsection (3B) below."

The FA 2006 attempted to stop certain arrangements related to s.48(3) in particular, and available as death-bed planning, which involved the purchase of interest in possession in excluded property settlements.

"Interest in possession" in subsection ((3B)(a) bears the meaning which it was given in *IRC v Pearson* [1980] STC 318, i.e. "a present right of present enjoyment"). Subsection (3B) would not apply where there was a disposition of an interest which was valuable but something less than an interest in possession, e.g. an interest subject to a power of accumulation. (Although Lord Russell in *Pearson* considered that a power of accumulation did not prevent the existence of an interest in possession: see p.328 g-h.) Accordingly, the property in the settlement which had an interest subject to a power of accumulation would, in Timothy's view, remain excluded property.

Residence of Trustees

See Income Tax Act 2007, TCGA 1992 s.69. FA 2006 Schedule 12. Timothy noted the absence of a professional trustee exemption. This has been said to be due to the influence of the EC State Aid Rules. Moreover, such a trustee could be treated as UK resident at any time when he acts as a trustee in the course of a business carried on in the UK through a branch, agency or permanent establishment there.

Timothy stressed that there are considerable dangers/grey areas for trustees in the application of these tests, e.g. what happens where the non-resident trustee conducts "back office functions" in the UK? What is the significance of *de facto* use of offices in the UK? What is the position where a trust company carries out some functions in relation to **one** trust but **not others** in the UK? Correspondence with STEP suggests that the trusts in relation to which no work was done in the UK are not affected. But …

4. What to do with Trusts created before 22 March 2006? – Rory Mullan ("Rory")

The categories of trust which will not be subject to the relevant property regime can be seen to be as follows:

1. Qualifying interest in possession trusts;

2. Charitable trusts;

3. Accumulation and maintenance trusts falling within s.71 IHTA 1984 as amended;

4. Trusts for bereaved minors (s.71A IHTA 1984);

5. Age 18 to 25 trusts (s.71D IHTA 1984);

6. Pre 12 April 1978 protective trusts (s.73 IHTA 1984);

7. Pre 10 March 1981 disabled persons trusts (s.74 IHTA 1984);

8. Employee trusts (s.86 IHTA 1984) satisfying the criteria in s.58(1A) to (1C) IHTA 1984;

9. Qualifying maintenance funds for historic buildings (Schedule 4 IHTA 1984);

10. Qualifying pension schemes;

11. Trade or professional compensation funds; and

12. Excluded property trusts.

As regards trusts existing on 22nd March 2006, the most relevant categories are qualifying interests in possession and accumulation and maintenance trusts, for these are the two most significant classes of trusts which have been affected by Finance Act 2006. As a general rule, a qualifying IIP is likely to be particularly useful and appropriate for beneficiaries with a long life expectancy, as the s.49 IHT charge on the capital can be significantly deferred. Using a TSI could be particularly appropriate plus suitable insurance arrangements. Contrast elderly or poor health beneficiaries where application of the relevant property, discretionary trust regime may well be a better alternative.

While it is certainly arguable that a wider more purposive approach should be adopted to the interpretation of the provision requiring **the entirety of the interest to come to an end** (s.49C condition 2) so that one applies it to individual funds, and not entire settlements, it cannot be assumed that such an approach would be accepted, particularly given the relatively clear wording of the section. Unfortunately, there is unlikely to be any decision on the matter before 6th April 2008.

When does an interest come to an end?

An issue which has become of central importance following the introduction of a parallel regime for the taxation of interests in possession relates to how one distinguishes one interest in possession from another. Is an interest in possession independent of the property in which it subsists? Does it depend upon the legal right giving rise to it? When, and to what extent, can alterations in that legal right give rise to a new interest? Unfortunately, little thought has been given to such issues, with the result that a great deal of uncertainty arises in trying to apply the legislation and in simply trying to deal with existing settlements.

One possibility is that one looks at settled property and considers the rights which attach to that settled property, or property replacing it from time to time. So long as such rights give rise to an interest in possession, then the same treatment applies, regardless of whether those rights derive from the original trust document, a subsequent appointment, a statutory provision or a different settlement to which the settled property has been added.

Alternatives as to Accumulation and Maintenance trusts subsisting on 22nd March 2006

1. *Amend so that beneficiary becomes entitled at 18*

   It would be necessary to make such an amendment by 6 April 2008. The beneficiaries will necessarily have to be under the age of 18 at that time. Clearly, the tax saving achieved using this approach will need to be weighed against the disadvantage of restricting flexibility and therefore the trustees' options in the future. If the beneficiaries are young enough to enable this approach to be adopted, it may be the case that such flexibility will be more necessary in the future.

2. *Appoint absolutely*

   Where the beneficiaries are under the age of 18, appointing bare trusts with an extended statutory power of advancement, is likely to be a preferable solution for inheritance tax purposes to arranging matters so that s.71 IHTA 1984 continues to apply.

Another less controversial option which might be adopted for an accumulation and maintenance trust would be to convert it to an age 18 to 25 trust by altering the terms so that it came within s.71D IHTA 1984. This is expressly permitted by s.71D(3) IHTA 1984. Rory does not, however, consider that this will be an advisable course in most cases. This is because the charge under s.71E IHTA 1984 on property leaving the trust will be broadly the same as if the property had been relevant property during the period s.71D IHTA 1984 applied to the settlement. As such, there is no particular tax saving, while the requirements of the section make the trust much less flexible.