

AUTUMN PROFESSIONAL NEWSLETTER

INTRODUCTION

The Government made radical proposals in the 2006 Budget to change the way inheritance tax applies to trusts. These proposals are of considerable importance for life assurance protection and investment-based trusts. Given that the Finance (No. 2) Bill 2006 has now been enacted, incorporating various amendments made at Report and committee stage, we thought that now would be a good time to consider the impact of these new rules on the ability to use trusts with life assurance policies as a means of financial planning and, in particular, inheritance tax planning.

Trusts of life assurance policies come in many shapes and sizes ranging from trusts of term assurance policies for family protection through to trusts of second death whole of life policies for the provision of funds to pay inheritance tax and trusts of single premium investment bonds to provide the settlor with continuing access to original capital or regular sums.

So how do these trusts fare under the new inheritance tax regime for trusts?

First, it is important to note that there are special rules that apply to life assurance policies effected in trust **before** 22 March 2006. Unfortunately, those policies made subject to other than a bare trust after midnight 21 March 2006 are not afforded any special treatment and will be subject to the full rigour of the IHT discretionary trust regime. Policies made subject to a bare trust will remain outside of the discretionary trust regime.

THE IMPACT OF THE NEW LEGISLATION

The general theme of the new legislation is that (subject to a few minor exceptions) all new trusts that include any flexibility over the selection of beneficiary and all accumulation and maintenance trusts where benefits vest later than age 18 will be subject to IHT as if they were fully discretionary trusts. Bare trusts (ie. non-settlements) where the beneficiary is absolutely entitled will not, therefore, be subject to these rules.

In the past, the trust that has been most commonly used in connection with life assurance policies has been the "flexible" power of appointment interest in possession trust. The implications of using this type of trust are now:-

- a 20% lifetime IHT charge on gifts to the trust on the excess over the settlor's available annual exemptions and nil rate band
- a possible 10-year periodic charge on the then value of the trust fund

- a possible exit charge when property leaves the discretionary trust eg when it is paid out to a beneficiary.

In calculating these charges on a particular trust it is important to remember that in order to arrive at the rate chargeable it is necessary to take account of the chargeable transfers made by the settlor in the 7 years before he established the trust in question. Up until now the vast majority of non-exempt gifts have been PETs but, as time goes by (assuming that people continue to establish trusts that are not bare trusts), most of these will be chargeable transfers.

It is also important to note that certain exemptions/reliefs do not apply as regards the IHT discretionary trust regime, for example

- the reverter to settlor/settlor's spouse exemption and
- the spouse exemption (when assets are paid into the trust or when one beneficiary dies and his/her spouse inherits)

POLICIES EFFECTED IN TRUST BEFORE 22 MARCH 2006

If a life policy effected before 22 March 2006 is held on interest in possession or accumulation and maintenance trusts that came into effect before 22 March 2006 and premiums continue to be paid after that date, the arrangement qualifies for transitional protection as an asset of a pre-Budget settlement. This means that continued premiums paid into a policy effected in trust before the Budget (22 March 2006) will not cause the policy to be subject to the new IHT trust provisions that apply to post 21 March 2006 trusts provided:-

- the power of appointment is not exercised after 5 April 2008 to appoint a new beneficiary who is not absolutely entitled; and
- the terms of the policy are only varied in accordance with the original policy conditions

A pre-Budget policy trust will also stay out of the discretionary trust regime if a change of beneficiary occurs (even after 5 April 2008) by reason of the death of a beneficiary who had an interest in possession.

A review of pre-Budget flexible trusts before 6 April 2008 would thus seem to be a very worthwhile operation.

POLICIES EFFECTED IN TRUST AFTER 21 MARCH 2006

Turning now to new policies in trust, what are the planning opportunities that now exist where the client requires a degree of control and flexibility over the gift? First, it is important to remember that it is always open to the individual to retain

PET treatment and avoid periodic/exit charges by using a bare trust. However, in such cases the individual sacrifices all rights to change a beneficiary.

It is convenient to consider protection policies and investment plans separately.

1. PROTECTION POLICIES

(a) Gifts into trust

On the basis that a regular (annual premium) is being paid, if the appropriate relevant conditions are satisfied, transfers should continue to be exempt under the normal expenditure out of income exemption and/or annual exemption. If the transfer is not exempt it will be chargeable. If large enough (£10,000 cumulative in a tax year or £40,000 cumulative over the previous 10 years) it will need to be reported (see below). For business trusts the premiums will usually be part of a commercial arrangement with no gratuitous intent and so be exempt.

(b) Periodic and exit charges

- Every 10 years, a periodic charge can arise. The effective rate of tax will then be applied to the value of the settled property at the date of the 10-year periodic charge.

Clearly the value of a life policy will be important to determine the 10-year IHT charge. Life policies which have a substantial sum assured and low/nil surrender value (such as whole of life and term policies) will usually have a low market value until the death of the life assured unless the life assured is in serious ill health. Section 167(1) IHT Act 1984 operates to substitute a premiums paid value for market value in the case of a “permanent assurance” (eg whole of life policy) and certain term assurances. HMRC Capital Taxes has confirmed that the “not less than the premiums paid” rule will apply in calculating the 10-year periodic charge.

IHT problems should therefore only generally arise where either:-

- the life assured dies, the life office pays the sum assured to trustees yet cash remains in the trust at the 10-year anniversary or
- the life assured is in serious ill health on the 10-year anniversary so that the policy has a market value in a hypothetical seller/buyer situation or
- the premiums paid under a non-term policy are sufficiently significant to trigger a charge.

In cases where there is a risk of a charge arising it may be more appropriate to consider splitting the cover into a number of policies at outset, each subject to a separate discretionary trust. Provided those trusts are truly separate and independent (eg have different terms and are established on different days - albeit by the same settlor) then each trust will, in effect, be entitled to its own nil rate band on the 10-year anniversary (see *Rysaffe Trustees Co (CI) Ltd v CIR CA (2003) STC 536*) meaning that tax can be saved at that time should the proceeds have been paid to the trustees and retained in the trust. This, in turn, would reduce or avoid the potential exit charge on the subsequent release of the funds to a beneficiary. It is important that the initial gift into these multiple trusts (ie. the premium) should be exempt or gives rise to a very low chargeable transfer to maintain the efficacy of this type of arrangement.

- When property leaves the settlement an exit charge can arise on that property. The rate of charge in the first 10 years will normally be ascertained based on the value of the settled property at commencement and the cumulative total of transfers made by the settlor in the seven years preceding the creation of the settlement. This will usually mean there will be no exit charge in the first ten years. An exit charge after the first 10-year anniversary will normally be based on the tax charge at the last 10-year anniversary. So if there is no ten-year charge there will be no exit charge for the next 10 years.

2. INVESTMENT PLANS

(i) Trusts of single premium bonds

As a single premium bond is a non-income producing investment which does not produce profits which are subject to capital gains tax, it is a tax efficient trustee investment because many of the trust tax anti-avoidance rules do not apply. The 5% tax-deferred withdrawal facility gives the trustees an easy and effective way of taking cash out of the bond without an immediate tax liability.

The combination of a "flexible" trust and a single premium bond gives rise to a number of tax advantages. In particular, the use of a flexible trust enables an investor to:

- keep control as a trustee
- retain flexibility over which beneficiary will benefit and when
- secure investment growth tax efficiently outside his taxable estate

Of course, investors entering such arrangements should be happy they need no access to their investment because, if they are included as a potential

beneficiary, a gift with reservation will arise. If they do need such access a loan trust or discounted gift trust should be used – see (ii) and (iii) below.

The new IHT charges on trusts subject to other than a bare trust mean that an investment in a bond subject to a flexible trust will be treated as a chargeable lifetime transfer – previously it would have been a PET. It is therefore important to ensure that the gift does not exceed the donor's available nil rate band as otherwise an immediate tax liability will arise. If the first 10-year anniversary is approaching and an IHT charge looks likely thought could be given to removing the capital from the trust by making a payment to a beneficiary provided, of course, that that is acceptable and subject to triggering an exit charge. The rate charged will, however, be based on the value of the settled property when the trust was established not at the time the payment was made. This would be good if values have risen but not if they have fallen.

Remember for somebody who has not previously made a gift, up to £285,000 (£291,000 taking account of available annual exemptions) can be placed into trust. This would equate to £570,000 (£582,000) for a married couple.

(ii) Loan trusts

Loan trusts offer an investor the ability to receive regular tax efficient payments (loan repayments) whilst securing investment growth outside his taxable estate.

Most of these loan trusts are based on a loan being made to a flexible interest in possession trust and therefore most of section (i) above will apply. However there are important differences.

Many of the current arrangements are based on a loan only, ie. there is no initial gift, and so even for new (post-Budget) plans there will be no possibility of a chargeable transfer on establishing the trust. Even where gifts are contemplated in such arrangements, they would normally be small and so covered by the annual exemption(s). Loan repayments would not trigger exit charges.

The relevant value of the trust fund for the purposes of the 10-year charge will be the net value after taking account of the outstanding loan and many loan trusts will, as a result, be unlikely to get close to the nil rate band at the 10-year anniversary for some time. But in the situation where the settlor has made substantial chargeable lifetime transfers in the 7 years before establishing the loan trust, an IHT charge will be more likely. Clearly, each case will depend on its own facts. Where a charge could arise then establishing a series of separate loan trusts on different dates so that each could, in effect and in the right circumstances, qualify for its own nil rate band, could be beneficial.

In practice, there should be no immediate IHT consequences on the establishment of these trusts and, even for new flexible loan trusts, the proposed IHT implications may not be of the same magnitude as for trusts which involve gifts and chargeable lifetime transfers.

For those who do not need or value flexibility and wish to avoid the discretionary trust regime, loan trusts can be established on a bare trust basis.

The new rules will have only a limited impact on the effectiveness of loan trusts.

(iii) Discounted gift trusts (DGTs)

These trusts are materially affected by the changes in law, given that the sums involved are often considerable and almost all schemes (at least to date) have been based on flexible interest in possession power of appointment trusts. However, there are still considerable advantages.

These plans involve a discounted gift which is an amount normally considerably less than the total investment. The chargeable transfer for inheritance tax purposes when other than a bare trust is used will be based on the discounted value (ie. the amount invested less the discount reflecting the present value of the settlor's retained rights to regular cash payments). It will be necessary to inform HMRC on forms IHT 100 and 100a if the reporting limits apply and the discount may have to be agreed with HMRC at outset.

In the circumstances, it would not be advisable to establish a trust where the discounted gift might exceed the available nil rate band. Clearly careful consideration would need to be given to the amount of any likely discount and it may be best to err on the side of caution so that an immediate IHT liability does not arise.

Thought also needs to be given to how the periodic charge and exit charge may apply to these trusts.

(a) Periodic charge

One important factor in the calculation of the periodic charge is the value of any relevant property in the settlement immediately before the ten-year anniversary. Under a DGT the settlor has the right to certain capital payments on survival to specified future dates. HMRC has agreed (in private correspondence) that the rights of the settlor to these capital payments are held on bare trust for him so that these rights are not relevant property and not comprised in the settlement so the value of the relevant property in the DGT is the value of the funds held (ie. the single premium bond) in the trust less the value of the settlor's rights.

In addition, HMRC commented that while strictly speaking the settlor's rights would need to be revalued every ten years, which would require fresh underwriting, in practice it would be acceptable to add 10 years to the settlor's age at each 10-year anniversary provided the DGT was underwritten at outset. Of course, this practice could be reviewed if circumstances dictated it.

(b) Exit charge

The exit charge can arise, generally speaking, where property or part of the property comprised in the settlement ceases to be relevant property – section

65(1)(a) IHTA 1984. Does a potential charge arise when a payment is made out of the trust to the settlor?

HMRC has confirmed that, under a DGT, the settlor's cash payments, being payments from property that is not relevant property (ie. property held on bare trust for the settlor), would not give rise to an exit charge.

All of this is good news. It means that considerable sums can still be invested in discounted gift trusts and the administration involved for life office and adviser may not be as intensive as first thought.

For those not requiring flexibility the rigours of the discretionary trust regime can be avoided through the use of a bare trust.

PROBATE TRUSTS

These are trusts under which the settlor is entitled to a life interest with the power of appointment being vested in the trustees. The settlor is a potential beneficiary. The trust gives protection against the bond being treated as an asset of the settlor's estate for probate purposes. Because the settlor has an interest in possession under the trust no IHT saving was achieved (although it may have been possible to use the settlor's available nil rate band on death by providing for the property to pass via further trusts that become effective on his death).

Any new trust created along these lines will be treated as a discretionary trust for IHT purposes. Furthermore, the value of the trust fund will be in the estate of the settlor as a gift with reservation of benefit by virtue of he or she being one of the beneficiaries under the trust. Previously the gift with reservation of benefit provisions would not apply because of the settlor having an interest in possession.

This means that an initial gift to the trust could give rise to immediate lifetime IHT (and the periodic and exit charges) yet the value of the trust fund would still form part of the settlor's taxable estate.

On this basis, (and subject to any double tax relief that may be available under the Inheritance Tax (Double Charges Relief) Regulations 1987 in connection with the death of the settlor within seven years of the gift) it would not make any sense to create such trusts in the current form, especially if the initial gift gives rise to an IHT charge.

An Opposition amendment was tabled at committee stage proposing the removal of "self-settlements" from the discretionary trust regime. This was not however accepted.

WILL TRUSTS

A number of married investors effect single premium bonds on a single ownership (albeit joint lives) basis and other collective investments with a view to leaving those investments to a discretionary Will trust on their death first. This means that as well as using the nil rate band of the first to die at that time, because of the trustees' power of appointment the surviving spouse will be able to benefit from the trust fund and so financial security is preserved. The trusts were always subject to the discretionary trust regime and will continue to be. It is important for trustees to regularly review the trust to ensure that the periodic and exit charges do not arise or are minimised.

For those wishing to leave assets on life interest trusts for spouse and then to children (so as to defer IHT but not use the nil rate band) originally, under the Finance (No. 2) Bill, the type of life interest trusts that could utilise the spouse exemption on the first death were quite restrictive. However, following Government-tabled amendments to the Bill now incorporated in the Act, more flexibility now exists.

Discretionary Will trusts for clients who are married or in a registered civil partnership continue to represent very effective IHT planning offering savings of up to £114,000 on the second death with continuing financial security for the surviving spouse/civil partner.

BUSINESS TRUSTS

Business trusts are used to put cash in the hands of surviving business owners on the death (or critical illness) of a business owner so that the deceased's share in the business may then be purchased.

These are typically based on a modified power of appointment trust – with beneficiaries confined to business partners/co-shareholders. If the arrangement is made on a fully commercial basis between the partners/co-shareholders then it is relatively well established that no transfers of value/gifts take place when the trusts are set up or premiums paid and so no IHT gift with reservation arises. This should not change under the new provisions.

However, this “commercial basis” does not seem to exclude business trusts from the discretionary trust regime if it could otherwise apply. Therefore, whether such trusts will be subject to the discretionary trust regime will depend on the same conditions already discussed for existing and new interest in possession trusts.

Existing trusts should continue in the same way as ordinary flexible trusts. Care needs to be exercised as under some trusts there is an automatic provision for a change of default beneficiaries (ie. beneficiaries with an interest in possession) on changes of business partners/shareholders. Such an automatic or separately executed change during a beneficiary's lifetime would have the effect of bringing the existing trust into the new provisions if it occurs after 5 April 2008 or is other than the first such change before this date. But again, unless the policy had a significant market value there would probably be no detrimental IHT consequences.

On the basis that typically a term assurance would be used in connection with such a trust, significant inheritance tax liabilities should not arise under the periodic charge or exit charge. A potential problem could only generally arise after the sum assured is paid on death/critical illness and remains in the hands of the trustees until distribution and a 10-year anniversary arises while funds are still in trust. The exception to this would be those cases where the life assured is in a prolonged period of ill health and so the policy has a value or where the policy is other than a term policy and the premiums paid are substantial. Again, a multi-policy multi-trust strategy (with trusts established on different days) should be seriously considered.

It should be remembered that there are still outstanding pre-owned assets tax questions on such policy trusts although, again, the practical implications of these provisions may not be serious.

Where appropriate, avoiding the discretionary trust regime by using registered pension term assurance or corporate (non-trust) policies may become popular.

CONCLUSIONS

Whilst the Finance Act provisions extending the discretionary trust rules to all trusts (other than bare trusts) is a blow to trust tax planning, this does not signal the end to such planning.

There is significant scope for planning through protection and lump sum plans in trust. Combinations of trust and plan types are likely, we think, to become more popular. One thing is certain, having access to well-informed, experienced advice is essential.

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