

Budget Update 1 - Fundamental Changes to the Taxation of Trusts

The Chancellor announced in the Budget on 22nd March fundamental changes to the way trusts are charged to inheritance tax (“IHT”), overturning the system that has been in place for the last 30 years. The Finance Bill, incorporating these changes, has not yet been published and will not become an Act of Parliament until about August this year, in addition the Society of Trust and Estate Practitioners will be making representations to parliament, so there may well be some amendments made over the coming weeks.

The provisions announced in the Budget are outlined below with an overview of the three types of trusts for IHT purposes, their pre 22 March status, the status of trusts created after 22nd of March and how the changes will affect existing trusts.

The position prior to 22 March

Put simply, for IHT purposes there have been three types of trust:

Interest in Possession Trusts – that is trusts under which someone (a “life tenant”) is entitled to the income of the fund in question, which have been treated for IHT purposes as part of the free estate of the life tenant, so that IHT has been payable on the trust fund on the death of the life tenant.

Accumulation and Maintenance (“A&M”) Trusts – that is trusts for children under the age of 25, which have been treated as exempt from IHT until the child in question reaches the age of 25, after which they have qualified as interest in possession trusts.

Discretionary Trusts – that is trusts under which the trustees have power to pay the income or capital among a class of beneficiaries as they see fit, which have been taxable under their own regime under which:

- IHT is payable at 20% when property is settled;
- The trust fund is subject to a tax charge every 10 years at a maximum of 6%; and
- There is “exit” charge proportionate to the 10 yearly charge when funds are appointed from the trust fund between 10-year anniversaries.

Additions to and appointments from interest in possession and A&M trusts in someone’s lifetime have been treated as “potentially exempt transfers” and therefore exempt from IHT so long as the donor or life tenant survived the transaction by seven years.

The position post 22nd March

Trusts created on or after 22nd of March

Interest in Possession Trusts - In future the old rules will only apply to an interest in possession trust which is 1) created on someone’s death 2) will only last for the lifetime of one life tenant, and 3) vests in someone outright when the life tenant dies.

Any interest in possession trust created by Will which does not comply with the above criteria, and any interest in possession trust created in someone's lifetime, will in future be taxed to IHT under the regime applicable to discretionary trusts described above.

Accumulation and Maintenance ("A&M") Trusts – New A&M trusts which are created on the death of a parent for their minor child will still be treated under the old rules so long as the child becomes entitled outright at the age of 18. Any new A&M Trust that does not satisfy this criteria (for instance if the child does not take outright until 25) will be taxable in the same way as discretionary trusts referred to above.

Existing Trusts

Interest in Possession Trusts - For trusts in existence on 22nd March the current treatment will continue until the current interest in possession comes to an end. If someone then becomes entitled outright IHT will be payable on the trust fund as though it was part of the free estate of the deceased life tenant, as under the old rules. If the interest in possession comes to an end in the life tenant's lifetime that will be treated as a "potentially exempt transfer and no IHT will be payable if he or she survives by seven years.

If the interest comes to an end but the property remains in trust; that will be treated as the creation of a new trust, and the IHT regime applicable to discretionary trusts will apply.

There is a transitional relief that if a new interest in possession comes into effect before 6th April 2008 on the cessation of one that existed before 22nd March, whether as a result of the death of the previous life tenant or otherwise, it will be treated as though that new interest in possession was in place before 22nd March (and therefore the old rules will continue to apply to it).

A&M Trusts – These will become taxable under the regime applicable to discretionary trusts from 6th April 2008. However, if an existing A&M trust is modified before that date so that the beneficiaries will be come absolutely entitles at 18, the pre 22nd March regime applicable to A&M trusts will continue to apply.

Trusts for the Disabled

There is a saving provision for these, and they will continue to be taxable under the old regime whether they are created on death or in the settlor's lifetime.

Comments

As the Finance Bill progresses through Parliament we will keep you informed of further changes. If you are concerned about your position please contact your regular advisor. If you do not have a current advisor but would like to seek professional advice, please contact our Trusts and Tax team. Contact information can be found on our website at www.wilsonslaw.com

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