

Inheritance Tax and Trusts Post-Finance Act 2006

How are Trusts now charged to Inheritance Tax ("IHT")?

In general, trusts with assets up to the value of the IHT threshold (£285,000 2006/07) remain unaffected.

With a few exceptions, trusts are now subject to the "relevant property regime" which has traditionally applied only to discretionary trusts. This means that:

- ◆ Lifetime transfers into any trust (new or existing) over the IHT threshold will trigger an IHT charge at 20%. This charge does not apply to a trust created on death but your Estate may at that point attract an IHT charge of 40%.
- ◆ Trusts will be subject to an IHT charge every ten years. This is currently at a maximum rate of 6% on the value of the trust assets at the ten-year anniversary.
- ◆ There will be an IHT charge when capital leaves a trust (known as an exit charge). This is currently at a maximum rate of 6%.

Do I need to review my Will?

Some of the changes proposed in the Budget (which attracted a great deal of press attention) have not been included in the Finance Act. The good news is that trusts continue to have a valuable role to play in Wills. The main circumstances in which you may now need to consider amending your Will are:-

- ◆ If you have left your spouse (or civil partner) an income interest in your estate rather than an outright gift the IHT treatment of that interest has not changed and spouse exemption will be available when you die. A life interest trust continues to provide useful non-tax benefits, particularly in the case of a second marriage. However, the flexibility for ongoing tax planning which was previously provided by widely drawn life interest trusts has been removed. The removal by the Trustees of a spouse's life interest is a gift by that spouse. If his or her interest is removed in assets which he or she continues to enjoy, the gift is capable of being a gift with reservation of benefit. So while the structure will not attract an immediate charge to tax, its tax planning benefits have been removed. Unless there are non-tax reasons for including the Trust, you may prefer to revert to a simpler structure when you next review your Will.

- ◆ If you have made provision for your own children to inherit at a particular age, you will be pleased to know that the original Budget proposal to the effect that these assets would fall within the relevant property tax regime if your children inherited after the age of eighteen have now been amended. There is however a (relatively small) charge to tax between the ages of 18 and 25 and there will be tax disadvantages if you had specified an age beyond 25 for your children to inherit. You should review your Will if you have specified any particular age for your children to inherit. This more favourable treatment does not apply to gifts to grandchildren
- ◆ If you have made provision for anyone other than spouse, civil partner or children to benefit from a trust under your Will, then you should review that. A trust arises whenever you have specified an age at which beneficiaries should inherit. There are now fewer opportunities for setting up IHT-favourable trusts in Wills for grandchildren or other beneficiaries.

We are pleased to be able to assure clients that **nil rate band discretionary trusts** in Wills are unaffected by the Finance Act 2006 and remain a useful IHT planning tool. Gifts to UK domiciled spouses and charities remain exempt.

Lifetime Trusts

All trusts which have been created during lifetime, rather than by Will, need now to be reviewed in the light of the Finance Act 2006, apart from

discretionary trusts which are unaffected by the changes.

Existing Life Interest Trusts

These trusts will continue under the previous tax regime until the interest of the current income beneficiary comes to an end. If that happens before 6th April 2008 in favour of a subsequent income beneficiary, the familiar tax treatment will continue until the death of that individual. This gives rise to planning opportunities which need to be taken before 6th April 2008. Thereafter, the termination of the income beneficiary's interest will cause the trust to become subject to the new tax regime (unless the life interest ends on death and is succeeded by a life interest for that person's spouse or civil partner)

Existing Accumulation and Maintenance (A&M) Trusts

These were commonly set up for children or grandchildren and all existing A&M Trusts need to be reviewed. They will become subject to the new rules on 6th April 2008 unless the terms of the trust are changed in the meantime. If the terms are changed to give capital and income to beneficiaries outright at eighteen, then the IHT charges will be avoided. If beneficiaries are given both capital and income between the ages of 18 and 25, there will be an IHT charge at a rate between 0% and 4.2% depending on the age at which the beneficiary receives their entitlement. Trusts which continue beyond beneficiaries turning 25 are in the worst position. Trustees will have to consider carefully the circumstances and best interests of their beneficiaries as well as the IHT and Capital Gains Tax consequences of amending the terms of the trust.

Any addition of assets to an existing trust will bring that trust under the new IHT regime.

Trusts - the Future

New trusts will all be under the new regime unless they qualify as a trust for the disabled. However, trusts remain a useful tool for asset protection and for IHT planning, especially in the following circumstances:

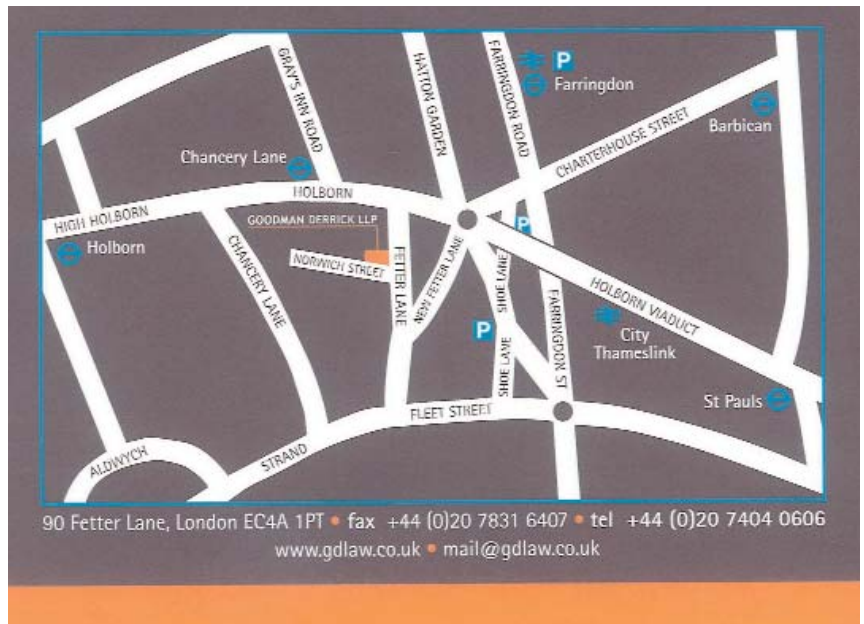
- ◆ A nil rate band trust can be created every seven years. A married couple can set aside £570,000 at current rates without any charge to IHT. If they start planning ahead in their fifties and have a life expectancy into their eighties, this would give the opportunity to shelter over £2m in trust without coming within the new rules.
- ◆ Bare Trusts for minors are likely to increase in popularity.
- ◆ Trusts set up with assets that qualify for business or agricultural property relief avoid the 20% IHT charge on creation and will suffer the 6% charge only if the assets cease to qualify for that relief. Among other assets, this applies to shares listed on the Alternative Investment Market (AIM).
- ◆ Substantial pension death benefits and life assurance policies can be put into trust without triggering the 20% charge on creation. Discounted Gift Trusts also offer planning opportunities.
- ◆ A parent sharing their home with an adult child can gift a part of that property to the child without falling foul of the reservation of benefit rules or pre-owned assets tax.

- ◆ Deeds of Variation remain available. If a Deed of Variation within two years of date of death creates a trust, this is treated for IHT purposes as made by the deceased. So the original beneficiary can remain a beneficiary of the trust and retain control as trustee but with the assets remaining outside their own estate.
- ◆ Careful use of exemptions can save significant amounts. This relates not only to the annual exemption of £3,000 but also to regular expenditure out of income exemption. This is available to those with surplus income who can continue to contribute significant sums to trusts without triggering any IHT.
- ◆ Finally, corporate or family partnership structures may be developed as an alternative to trusts in order to transfer assets between generations in a tax-efficient manner.

If you would like more information about Wills, Trusts and IHT planning please contact us. The partners and consultants in the team are:

Ian Bradshaw	0207 421 7917
Clare Jeffries	0207 421 7942
Diana Rawstron	0207 404 0606

This fact sheet is not intended to be a comprehensive statement of the law but a general overview of the recent Budget changes and options which may be available. Professional advice should be taken before any action in reliance on the content



Further information

If you would like more information about any of Goodman Derrick LLP's Private Client department please telephone and ask to speak to a member of the Private Client Group or visit us at www.gdlaw.co.uk

Goodman Derrick LLP
90 Fetter Lane
London EC4A 1PT

tel +44 (0)20 7404 0606
fax +44 (0)20 7421 7966