DIXON WILSON
CHARTERED ACCOUNTANTS

FAMILY TRUSTS AND THE 2006 BUDGET – BRIEFING FOR CLIENTS

Whether knowingly or not, many people have an interest in family trusts, either as beneficiary, potential beneficiary, settlor, or trustee. Most wills, apart from the very simple, create a trust to come into effect in certain circumstances.

The Government is in the process of changing in many ways the tax rules governing trusts. The budget proposes changes to the capital taxation of new trusts in which an individual has a right to receive income and in relation to all accumulation and maintenance trusts (i.e. trusts for children and grandchildren under the age of 25).

The proposals are as follows:

NEW TRUSTS

Lifetime transfers into accumulation and maintenance trusts or interest in possession trusts will no longer be free from an Inheritance Tax (IHT) charge even if the settlor lives for seven years from the date of the transfer, unless the trust is for a disabled person. Instead there will be an immediate IHT charge of up to 20% of the chargeable value of the assets transferred into the trust with a further charge arising if the settlor dies within 7 years from making the gift.

Charges will also arise on every tenth anniversary of the creation of all new trusts (often known as 'ten year charges'), payable at 6% of the net asset value of the trust fund, and when capital is taken out of the trust (known as an 'exit charge'), payable at up to 6%.

EXISTING ACCUMULATION AND MAINTENANCE TRUSTS

If the trust provides for the assets to go to a beneficiary absolutely at age 18 – or where the terms on which they are held are modified before 6 April 2008 to provide for this - the current IHT treatment will continue.

Where the terms of the trust do not meet these criteria, the ten year charge and exit charge regime, described above, will apply from 6 April 2008.

EXISTING INTEREST IN POSSESSION TRUSTS ('IIP TRUSTS')

The current rules for existing IIP Trusts will run on until the interest held in the trust property at 22 March 2006 comes to an end. If the interest then becomes absolute ownership of the trust property, this will be a transfer by the person with the interest in the property – either a transfer on death or a 'potentially exempt transfer' if they are still living – and will receive the same IHT treatment as now. The trust will have no further IHT consequences.

If the interest comes to an end so that the property remains on trust, the following will apply:

- if it comes to an end during the lifetime of the person beneficially entitled to it, this will be treated as creating a new trust. Unless the new trust is for charitable purposes, the rules set out above will apply and the transfer will therefore be immediately chargeable to IHT. Thereafter the trust will be subject to the ten year charge and exit charge regime; and
- if the interest comes to an end on death, the trust assets will form part of the person's IHT estate, as now, and the settled property will, unless the charity exemption applies, then be subject to the ten year charge and exit charge regime.

GIFTS WITH RESERVATION

Anti-avoidance legislation has been in place for many years to charge IHT on assets where an individual has previously given them away but continues to use or occupy them on a non-arms length basis. These provisions are being extended to include certain arrangements which will arise from the new rules for trusts.

Where an individual is beneficially entitled to an interest in settled property, and is treated for IHT purposes as owning the property, a termination of the interest in the individual's lifetime on or after 22 March 2006 will be treated as a gift for purposes of the IHT 'gift with reservation' rules. If they retain the use of the settled property after their interest in it ends, it will remain chargeable in their hands in the same way as if they had formerly owned it outright.

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CAPITAL GAINS TAX CONSEQUENCES

Changes to the IHT treatment of trusts will have a number of implications for CGT. Some transfers into and out of accumulation and maintenance trusts and interest in possession trusts that will become immediately chargeable to IHT will now be eligible for capital gains hold-over relief.

In some circumstances there will no longer be an uplift to market value of the capital gains tax base cost of trust assets following the death of a life tenant of an interest in possession trust.

OUR VIEWS

These changes which – if adopted – will introduce an IHT charge every 10 years for most accumulation and maintenance trusts and many newly created life interest trusts will fundamentally change the trust scene. We must expect that it may be some years before the new legislation for these new rules is in its final form.

You should also be aware that the Law Commission is currently examining the way in which the income of a life tenant should be calculated. Their current views would increase the income of life tenants where trusts hold assets which are primarily held for capital growth.

OUR ADVICE

Our advice to clients at the moment, and before the publication of the Finance Bill, is as follows:

1. Do not panic. In the absence of the legislation any action taken may be the wrong action.
2. Remember that most business property and much agricultural property continues not to be liable to IHT, whether held in or outside a trust.
3. Do not add to any trusts unless you have to do so in order to keep up the premiums on life insurance policies or to maintain a pattern of regular giving using the normal expenditure out of income exemption for IHT purposes.
4. Do not create any new trusts unless there are very good family – as opposed to tax reasons – for so doing.
5. If a new will is drafted before the new legislation is available do what you think is right for the family, but do not incorporate trusts unless you think there is a real need for them.
6. Consideration may need to be given to the terms of existing wills where provision for a trust is included.

If you would like further information or advice, please contact any of our partners with whom you are already in contact or one of the writers:

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