



Private Trusts – Any Future?

BRIEFING

It is true that the tax regime for trusts, specifically Inheritance Tax (IHT) and Capital Gains Tax (CGT), has taken something of a beating in recent years. As a result, what used to be strong tax reasons for making trusts have now gone, the intention of the legislature being to create something of a 'level playing field' between the alternatives of making outright gifts and making gifts into trust.

The message of this note is that 'trusts are alive and well - though perhaps in less good health'.

Certainly the Finance Act 2006 so-called 'Alignment of IHT for Trusts' has rather skewed the balance against trusts and there have over the last 20 years or so been successive onslaughts against offshore trusts in particular - although this Briefing is restricted to UK resident trusts. However, the advantages of trusts in offering protection of capital for imprudent or unfortunate members of the family and continue to make them an important part of the tax planner's armoury. (However, professional fees, both initially and on an ongoing basis, should always be borne in mind, as part of the cost-benefit analysis.)

In the context of estate planning, this Briefing will focus on IHT issues, but with CGT and Income Tax very much in mind. Stamp Duties are also mentioned. Budget Day 2006 turns out to have been something of a watershed for IHT on trusts. And so we need to deal separately with qualifying Interest in Possession Trusts and indeed

Accumulation and Maintenance (A&M) Trusts made before 22 March 2006.

Private trusts explained

The trust (or, broadly, settlement) is a well-established feature of the English common law. It is distinct from a company: while a shareholder cannot be ordinarily responsible for the debts of the company, an individual trustee is personally liable for the debts and obligations of the trust (subject to specific indemnities under the trust deed, enabling recovery of a loss from the trust fund). It is the trustees together who legally own the capital of the trust, but for the benefit not of themselves, rather of the beneficiaries.

The beneficiaries are those who may benefit under the trust, whether specifically named or defined by reference to a class. (A trustee can be a beneficiary.) The 'settlor' is the person who makes the trust or who adds property to it. Typically both the settlor and spouse (which includes for these purposes 'civil partner') will be irrevocably excluded from all benefit under the trust, as otherwise there will be adverse tax consequences. Broadly, the capital will still be treated as part of the settlor's estate for IHT purposes (under the 'reservation of benefit' rules) and the gains and income of the trust will be treated as those of the settlor (the trust being 'settlor-interested').

Trusts are distinguished from each other largely by what happens to the income. If the income as it arises must (after deduction of any necessary trust



expenses) be paid to one or more beneficiaries, that is an 'interest in possession' trust. If, on the other hand payment of the income lies at the discretion of the trustees, that is a 'discretionary' trust. There could also be an 'accumulation' trust where the trustees are required to accumulate the income for a period of time, e.g. until a particular beneficiary reaches the age of 18. A trust deed may make it clear that the beneficiary is entitled to the income as it arises even though the trustees will not pay it to him until the age of 18; this is an interest in possession trust.

A trusteeship is not something to be taken on lightly!

While certain powers and restrictions may be imported into a trust by the rules of the legislation, generally, it will be the terms of the trust deed which will govern what the trustees may – and may not – do. Incidentally, merely because trustees have power to do something such as invest the whole of the trust fund in a single non-income producing asset, that does not mean that it is the right thing to do. And trustees generally will be personally liable if they act negligently, subject always to the provisions of the trust deed.

March 2006

Prior to Budget Day 2006, the potentially exempt transfer (PET) regime applied to qualifying interest in possession and A&M Trusts. Under the PET regime one can make a gift of whatever amount to an individual and, providing the donor survives for seven years, the gift becomes exempt; otherwise it is treated as chargeable. Further, the beneficiary

of such a 'qualifying' interest in possession trust was treated as beneficially entitled to the underlying assets, so that they come into charge on the beneficiary's death along with the free estate. There was also, until 22 March 2006, the favoured A&M trust which took such trusts (broadly for the benefit of children and grandchildren under the age of 25) out of the charging regime for discretionary trusts described in the next paragraph. Since 22 March 2006 no new interest in possession trusts or indeed A&M trusts can be made, except for a qualifying trust for a disabled person which can still be a PET.

The other regime for trusts, called typically by HMRC as the 'mainstream' regime, applied before 22 March 2006 merely to discretionary and accumulation trusts. Now it applies to practically all new lifetime trusts and is called the 'relevant property' regime. A gift to a trust, whether interest in possession or discretionary for Income Tax purposes, will be an immediately chargeable transfer. There is the benefit of the nil-rate band (£325,000 in 2011/12) insofar as not already used by chargeable transfers within the last seven years, plus this year's and may be also the 2010/11 annual exemption of £3,000, but any value transferred above that will attract an immediate IHT charge of 20%.

Furthermore, on every 10-year anniversary of making the trust there is a periodic charge, the amount of which will depend on a variety of factors, though it can never be more than 6%. Whenever capital leaves the trust there is an exit charge, the percentage of which depends on the amount of the last periodic charge (or entry



charge) and the length of time that has elapsed since. As with a gift to an individual, qualifying business and agricultural property will attract a deduction of up to 100%, operative on both creating the trust and in computing any periodic or exit charge.

Will trusts

This Briefing is devoted primarily to lifetime trusts.

However, a testator can leave a qualifying interest in possession trust under the Will, whether to a spouse (which will be exempt) or to a child or other individual (which will be immediately chargeable). And there are certain other IHT favoured trusts for children under Wills ('age 18' and 'age 18-to-25' trusts).

CGT

The termination of a trust on death is treated in the same way as the death of an individual owning an asset outright. That is, any inherent chargeable gain is 'washed' and the new owner takes the asset for CGT purposes at its then current value. (The only slight qualification to this is that, if on entering the trust the gain was 'held over', that is, electing to defer the gain until a disposal by the transferee, that held-over gain comes back into charge on death.) If an asset is transferred out of trust during the beneficiary's lifetime, even to the beneficiary himself, that will be a chargeable disposal and the gain will be assessed on the trustees at the current rate of 28%, subject to any available annual exemption (of up to £5,300 for 2011/12) – or, indeed, entrepreneurs' relief. If the

asset is a defined business asset (including one that attracts agricultural property relief (APR) from IHT), then the gain may be held over by election, so that the trustees' base cost is taken on by the new owner.

If an asset is advanced absolutely out of a relevant property trust, then whether or not the asset is a defined business asset, an election for hold-over relief may be made. So hold-over relief is not available to relieve a gain on a non-business asset exiting a qualifying interest in possession or (unless rights to income and to capital vest together) an A&M trust.

Trusts in being at 22 March 2006

These were not immediately affected by the new legislation, insofar as the then qualifying interest in possession has continued to run. However, FA 2006 may affect such trusts when the then qualifying interest in possession terminates, whether on death or during lifetime. If the interest in possession comes to an end during the beneficiary's lifetime and the trust fund is transferred to the beneficiary, that is a non-event for IHT purposes, since the beneficiary is already treated as owning the capital. A transfer to any other individual is treated as a PET by the beneficiary (unless spouse exempt). And termination on death will be a chargeable transfer unless a surviving spouse/civil partner becomes absolutely entitled. Where, however, an interest in possession comes to an end and a successive interest in possession (or indeed a discretionary trust) arises, the trust fund will be treated as entering the relevant property regime, with a



chargeable transfer by the beneficiary. So there could be IHT to consider at that point.

No new A&M trust can be made since 22 March 2006, though trusts existing at that date will continue their course, typically until one or more beneficiaries become entitled to an interest in possession for Income Tax purposes (which will now not be a qualifying interest in possession for IHT) or become entitled outright. For Income Tax purposes an A&M trust will always be discretionary.

Trustees of A&M trusts as at 22 March 2006 had a choice of various actions to take before 6 April 2008. The continuing A&M regime would continue if the qualifying age of entitlement to capital was reduced to age 18 (if not already so under the trust deed); or the capital could have been advanced outright and the trust terminated; or, either expressly or if nothing was done by 6 April 2008, the capital will have entered the relevant property regime at that point. (CGT hold-over remains possible on non-business assets leaving an A&M trust where capital vests outright without an intervening right to income.)

Planning points

In the ordinary course a good rule of thumb is to carry out a review of one's estate planning, either every five years or if sooner on a significant change in legislation or in family circumstances. Certainly, in relation to any A&M trusts in being as at 22 March 2006, the time for review has gone – years ago on 6 April 2008! Many of these were

indeed allowed to 'slide' into the 'relevant property' regime – of which more below.

So far as continuing qualifying interest in possession trusts are concerned, they may well continue to serve their purpose, bearing in mind, however, that (subject to any available APR or business property relief (BPR)) the market values of the underlying assets will come into charge on the beneficiary's death, subject to any exemption for a surviving spouse/civil partner – except if the trust continues at that point, because the capital will fall into the relevant property regime and the spouse will not become or be treated as absolutely entitled.

So, if the exercise has not already been undertaken, it could be worth reviewing any such qualifying interest in possession trusts now in the overall context of the beneficiary's estate planning, to consider whether any action should be taken. Suppose, for example, the beneficiary no longer needs the income and the capital does not consist of qualifying business or agricultural assets (though these reliefs cannot be guaranteed to continue at up to 100%). There may be a case for advancing some or all of the assets down a generation now, subject to the usual issues of protection and security, in the hope that the beneficiary will survive the seven years, subject, however, to the CGT cost of up to 28%. So there may still be the balance between CGT at 28% (now) and IHT at up to 40% (ultimately) to be assessed.



The relevant property regime

Given the 10-year charge it has always been an axiom for what are now relevant property trusts that a review should be made say 6 months before any 10 year anniversary event, to determine (especially before the first one) whether all or part of the capital should be extracted before the anniversary. And this remains the case.

The particular planning point for the first 10-year anniversary charge is that, where the property enters the settlement with a chargeable transfer of nil, then whatever the then value, it can in principle be extracted from the settlement before the first 10-year anniversary without any IHT charge. Suppose that a discretionary settlement was made on 1 July 2001 within the nil-rate band which was then £242,000. Approaching 1 July 2011 the value in the trust is now £1m. Broadly, the 10-year anniversary charge will be £13,500 or 1.35%. If the circumstances were right, the property could be advanced out, under hold-over election for CGT purposes, to one or more beneficiaries before 1 July 2011 without any IHT charge.

This broad principle is subject to certain qualifications, e.g. where property has been added to the settlement, but especially where it was qualifying business or agricultural property that went into the trust, which in particular meant that there was no entry charge on commencement. For purposes of this rule such agricultural or business property is taken at its gross value, so only if the gross value at exit before (in our example) 1 July 2011 does not exceed £325,000 will there be no exit charge. On the other hand the

continuation in the trust of qualifying property will mean that there will be no 10-year charge anyway – or rather that IHT will be charged at 0%.

Planning points

Certainly, where qualifying agricultural or business property is concerned, it may well be worth making a new relevant property settlement where the gain can be held over for CGT purposes on entry, but always subject to the qualifying conditions, the continuation of the regime and family circumstances. The assumption generally is that the protection of a trust is thought to be worthwhile. So each spouse might consider making a nil-rate band settlement of £325,000 - or up to £331,000 depending on availability of annual exemptions or rather more where BPR or APR is available. With non-business property this is an exercise which can be done every seven years, with an eye on the relevant regime at the time and indeed the nil-rate band. (It is abundantly clear that the promise of a dramatic increase to £1m promised by the Conservative Party when in opposition can effectively be forgotten, given both the existence of the Coalition and rather more stringent economic circumstances. Indeed, the present £325,000 nil-rate band has been frozen until 2015.)

Income Tax

We have not said so much about this. A trust may be interest in possession for Income Tax purposes even though it is relevant property for IHT. The advantage for Income Tax is that the trustees cannot be liable at more than 20%. And indeed



such tax as they have paid, except the deemed 10% irrecoverable tax credit on dividends, may be recovered by the beneficiaries to the extent that they have the benefit of their personal allowance of £7,475 for 2011/12. This happens through submitting a repayment claim under the self assessment system on the basis of the form R185 issued by the trustees reporting the trust income and any tax deducted.

By contrast, where for Income Tax purposes the trust is discretionary or accumulation in character, while the first £1,000 of income will be taxed at no more than 20%, the balance will attract tax at 42.5% if dividend income (less the 10% tax credit) and otherwise 50%. This makes such trusts very expensive at first sight, that is trustees do not have the benefit of the basic rate and higher rate bands (as do individuals, with the 50% rate applying only to income over £150,000). Although there is the possibility of recovery of Income Tax by beneficiaries in the normal way, this will have a cash flow and therefore a timing disadvantage. And so there are and have been for a year or more strong reasons for ensuring that the trust is interest in possession for Income Tax purposes. This should be easy enough to arrange, subject always to the terms of the trust deed.

Bare trusts

The tax rules and principles set out above apply to what might be called 'substantive' trusts. By contrast, there is one type of trust which has no adverse tax implications over direct ownership and indeed is treated as if the beneficiary were the taxpayer, as being 'absolutely entitled' against the

trustees. This means that, although the trust property is held legally by the trustees, the beneficiary can (as long as he is age 18 or over) require the trustees to transfer the legal ownership to him at any time.

What is the point then of a bare trust? Obviously, for those under 18 who cannot legally hold land and shares, it provides an ownership structure which can be more IHT-efficient than a substantive relevant property trust. On the other hand, when the child gets to 18 he can do with the property what he will. And, more generally, such property is available to a creditor or to an aggrieved ex-spouse in matrimonial proceedings. That of course is the downside. However, generally it may be thought convenient in appropriate cases to have the trust property owned by trustees who can then ensure professional administration and management of the property (at the appropriate costs).

At all events, a gift to a bare trust will be treated as a potentially exempt transfer and therefore whatever the amount, will carry no IHT consequences unless the donor dies within seven years. A chargeable disposal for CGT purposes cannot be mitigated by a hold-over claim, except if the asset is a qualifying business asset.

Offshore trusts

These are trusts where the trustees are non-UK resident for UK tax purposes. Generally speaking, the trustees will not be subject to UK CGT even on UK situated land except when used in a course of a business. If UK trustees are replaced by non-



UK trustees, there will be an exit charge based on current values of the trust assets, at 28%. Moreover, where the settlor is alive and UK resident and he has an 'interest in the settlement' (that is, broadly, the settlor, spouse, children, their spouses, grandchildren, their spouses or companies controlled by any of them can benefit under the trust), the settlor will be liable to pay CGT on gains made by the trustees on an arising basis (the 'settlor charge'). While there is a right under UK tax legislation for the settlor to recover such tax from the trustees, they may be disinclined to pay up and indeed the trustees may argue that it may be contrary to the interests of the trust. Such deemed gains can include gains made by a non-UK resident company owned by the trustees which if UK resident would be a close company.

Further, there is the 'capital payments' charge, whereunder any UK resident beneficiary receiving a capital payment or benefit from the trust is treated as if any trust gains not hitherto attributed to beneficiaries were made by that beneficiary, together with a supplementary charge of 10% for every year that has elapsed between the making of the gain and the receipt of the capital payment, up to a maximum of six. So the maximum tax rate for a UK resident beneficiary receiving a capital payment could be 44.8%. Where the beneficiary is non-UK domiciled and the gains arise and are kept outside the UK, the remittance basis will protect him from charge so long as he is a 'remittance basis user' – that is, broadly, one who is paying the annual tax charge of £30,000 (or, as proposed by the 2011 Budget, £50,000).

Excluded property trusts

There is a further very significant IHT category of trust which should be mentioned, in the case where the settlor is non-UK domiciled on making the trust. For IHT purposes, a special deemed domicile rule operates, whereunder a person who is not otherwise UK domiciled is treated as UK domiciled if he has been UK resident for at least 17 out of the last 20 tax years. To the extent that the trust assets are situated outside the UK, this is called an 'excluded property settlement' and does not come into charge to IHT at all, whether on the death of the beneficiary or, where otherwise 'relevant property' in form, on creation or at any ten-year anniversary or exit charge. This rule applies even if the settlor is alive and has reserved a benefit.

Standard planning for someone with a domicile of origin outside the UK who is in danger of becoming deemed UK domiciled for IHT purposes is to consider making an excluded property settlement before that point.

For those who are clearly domiciled and resident in the UK an interesting angle presented by the excluded property settlement regime is as follows. Suppose your client is the UK resident beneficiary of a legacy under the Will of a long-lost (or even close) foreign domiciled relative. It is (somewhat curiously) possible for the client to vary the Will within two years for UK IHT purposes, so creating an excluded property settlement, being treated as made by the deceased non-UK domiciliary. Provided the assets are kept outside the UK, then for however long the trust continues it will under



current legislation be protected from IHT. Such a trust will be settlor-interested for CGT and Income Tax purposes and so might as well be UK resident.

Stamp duties

Generally speaking, transfers into and out of trust will be treated as gifts and will therefore benefit from the exemptions from both Stamp Duty for stocks and shares and Stamp Duty Land Tax for UK land. However, as with all transfers, if the shares or land are a subject to a liability which is assumed by the transferee (trustees or beneficiary), the amount of that liability is treated as chargeable consideration and so, subject to the thresholds (of £1,000 for shares and of £125,000 for residential or £150,000 for non-residential or mixed property) will attract Stamp Duty or SDLT.

Conclusion

We hope that this brief survey will have given you food for thought, perhaps assuring you that existing trust structures may still be doing their bit and/or indeed causing you to consider whether setting up a new trust might be the right thing to do. Trusts, however, do remain 'alive and well' and any reports of their death are much exaggerated.

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