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Private Client and Trusts

Trusts - following the Finance Act 2006.

The changes to the taxation of trusts introduced by the Finance Act 2006 have led to a flurry of media interest in this area. Here we provide an overview of these changes, together with practical suggestions on what should be done in the light of them.

This briefing is for general information only and is not intended as a substitute for taking appropriate professional advice.

Introduction

The effect of the Finance Act 2006 (the "Act") is that all new trusts, unless they come within the exceptions in the Act, will be taxed for inheritance tax (IHT) as discretionary trusts. This means that, after exemptions and reliefs and over the IHT 'nil-rate band', currently £285,000, IHT will be charged as follows:

- An immediate charge on the creation of a lifetime trust of 20% with a further charge of 20% being paid if the settlor dies within 7 years, subject to taper relief;
- An IHT charge of 6% every 10 years; and
- 'Exit' charges when capital is distributed from the trust. There is however no IHT payable on the death of a beneficiary.

Existing trusts may also be affected by the Act, as outlined below.

Exceptions - New Lifetime Trusts

The only exceptions to the new rules for new lifetime trusts are:
- Charitable trusts; and
- Trusts for disabled beneficiaries.

Exceptions - New Trusts Created on Death

Three new types of trust have been created by the Act, which are excepted from the new IHT rules:

- Immediate Post-Death Interest Trusts (IPDIs): these are trusts created by will or intestacy where the beneficiary becomes entitled to a life interest in assets of the deceased person. As before the Act, no IHT applies if the life tenant is the deceased's spouse or civil partner.
- Bereaved Minors Trusts (BMTs): these are trusts created on death by a parent, adopted parent, step-parent or someone with legal 'parental responsibility'. The child must take the trust property at 18.
- Age 18-25 trusts: if a child, as defined above, takes trust property between the ages of 18 and 25, a limited IHT charge will apply and will be a maximum of 4.2% of the value of the trust property over the IHT nil-rate band.

Charitable trusts and disabled trusts are also exempted from the new rules where they are set up on death.

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Provisions for Existing Trusts

The Act has provided for transitional provisions for Accumulation and Maintenance (A&M) trusts and Interest in Possession (IIP) trusts that were in existence before 22nd March 2006. This gives trustees a two year 'breathing space', until 6th April 2008, to review these trusts, in order to consider how they might be affected by the Act and to take appropriate action.

- A&M trusts: before 6th April 2008 when the new rules will apply to existing A&M trusts, trustees can consider, where applicable:
  i) giving the beneficiaries absolute interests in capital at age 18;
  ii) ensuring that the beneficiaries take the an absolute interest by the age of 25, limiting the ongoing IHT charges; or
  iii) letting the trust continue after the beneficiaries become 25 years old. The trust will then be taxed fully under the new rules, but this gives a unique opportunity to form a discretionary trust without an IHT entry charge.
- IIP trusts: these trusts can be amended in certain situations to extend their existing tax treatment beyond the current life tenant.
- There are also special transitional provisions for settled life contract policies.

Action Points

- Trustees should review existing trusts as soon as possible to ensure that action is taken at the correct time and that no opportunities are missed.
- Wills, especially complex wills, should also be reviewed in the light of the new rules.
- Ongoing tax planning in the new regime will require fresh strategic thinking and we can provide advice about the options now open to you.

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