TRUSTS
AFTER THE FINANCE ACT 2006 ...

KEY POINTS

- Interest-in-Possession regime scrapped
- New trusts 'discretionary' for IHT
- Initial, decennial and exit charges
- Limited reliefs for the very disabled and bereaved minors
- Reliefs to apply to trusts created on death - inter-vivos trusts chargeable as discretionary
- Some relief for trusts for young adults
- No quarter in divorce
- One million wills will need review
- Limited transitional relief
- All additions to existing trusts are chargeable transfers
- Growing impact of POAT and GROB provisions
- Certain 'excluded property trusts will now be chargeable
- Extended settlor-interested regime limits CGT holdover
- Common definitions of settlor and settled property

Briefing

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CONTENTS

Introduction	2
Pre-22 March 2006 Inheritance Tax rules	2
Inter-vivos trusts created on or after 22 March 2006	3
Trusts created on or after 22 March 2006 arising on death	5
Transitional provisions for trusts created prior to 22 March 2006	8
Additions to pre-22 March 2006 trusts	11
Deeds of Variation	11
Gifts with Reservation of Benefit	11
Pre-Owned Asset Tax	11
The Reverter to settlor provisions	11
Non-domiciliaries and excluded property trusts	11
Trusts in divorce cases	13
Capital Gains Tax changes and trust modernisation	14
Trustee residence and Anti-avoidance	17
Continuing tax planning opportunities	18
Alternatives to trusts	19
Conclusion	19

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1. INTRODUCTION

Radical changes to the Inheritance Tax (IHT) regime for trusts were announced on Budget Day, 22 March 2006. These proposals were entirely unexpected, and surprising in the light of the extensive consultation carried on in developing other reforms, announced on the same occasion, to Capital Gains Tax (CGT) and Income Tax. While the Budget Press Release BN 25 gave the first indication of the IHT proposals, the detailed proposals were released when Schedule 20 to Finance Bill 2006 was published on 6 April. The principle underlying the changes is that discretionary and life interest trusts should be subject to the same regime, except for limited exceptions for certain trusts established by will. The regime preferred is that previously applying only to discretionary trusts, and the general principle that life interest or interest in possession (IIP) trusts be treated as the property of the life tenant has ceased.

While it was known that Her Majesty's Revenue & Customs (HMRC) had concerns over certain issues - the use of surviving spouse trusts with powers of appointment to effect Potentially Exempt Transfers (PETs) being one - complete reform represents a serious over-reaction.

Trusts are used for many reasons, most of which have nothing to do with tax avoidance. There should be equality of treatment in tax terms as between absolute gifts to individuals and gifts into trust. The Government appeared to recognise this during the consultation process on the Income Tax and CGT treatment of trusts when it acknowledged the important role they could play in family and estate succession planning and that the tax system should be tax neutral in its treatment of trusts, neither penalising nor encouraging their use.

As IIP and discretionary trusts will now be subject to the same IHT charges, the creation of more nil-rate band trusts - many being effectively IIP trusts - should be expected. Depending on whether the increases to the nil-rate band keep up with the increase in the market value of trust property, a nil-rate band IIP trust may have an IHT liability when its first principal charge is calculated and there may be tax due on subsequent exit charges.

While there has been no change to the scope of IHT (and thus individuals who are neither domiciled nor deemed domiciled in the UK may not be so affected, nor in the main will excluded property settlements), the impact of the changes on existing trusts and wills is significant. The Society of Trust and Estate Practitioners has estimated that at least one million wills would have to be reviewed or rewritten. There has also been concern about the adequacy of the transitional provisions for trusts in existence at 22 March 2006. Fortunately, as a result of forceful representations made to it by professional bodies, the Government put forward significant amendments to Schedule 20, all of which were passed during the Standing Committee sittings or the Report Stage. The press comments referring to a Government 'U' turn are overstated and many desirable changes have not been made. Nevertheless, the amended Schedule 20 is far better than the original version.

2. THE PRE-22 MARCH 2006 IHT RULES

Leaving aside charitable or certain special purpose trusts, the IHT regime dealt with three principal categories of trust:

- Interest in Possession (IIP).
- Accumulation and Maintenance (A&M).
- Discretionary.

a) Interest In Possession trusts

The settlor (S) will settle assets into trust such that a beneficiary (B) has a life interest in the income and on B's death the capital will go to the remainderman (R). B is absolutely entitled to any income that the trust produces and the trustees must pay the income over to him. R is entitled to the capital on B's death. There might be successive life interests such that on B's death, rather than the capital going absolutely to R, a life interest in the income will go to a second or further beneficiaries (C) before R becomes absolutely entitled. Trustees have a statutory power to advance up to 50% of the capital to the remainderman during the lifetime of a life tenant provided the consent of the life tenant is obtained. Often the trust deed is more flexible than this and will allow unlimited capital advances at the discretion of the trustees.

For IHT purposes an IIP settlement was treated in the same way as an absolute gift to the life tenant. If the trust was inter-vivos, the initial settlement and any additions to the trust were PETs. There was no initial IHT to pay and no tax on death so long as the settlor survived for seven years - otherwise provided the settlor survived for three years or more, tax was reduced by taper relief. A settlement for the spouse/ civil partner of the settlor would benefit from the spouse/civil partner exemption. A self-settlement was ignored for IHT purposes.

An IIP trust set up by will would be treated in just the same way as an absolute legacy: thus the spouse/civil partner exemption was available. A settlement for anyone else (in so far as it was not covered by the nil-rate band) would be subject to IHT at 40%.

Property within the settlement was viewed for IHT purposes as part of the estate of the life tenant: thus a self settlement under which a settlor retained a life interest himself was a non-event for IHT purposes. The partial or total end of the life tenant's interest during his lifetime was a PET. If the trustees used any powers to advance capital to a life tenant, this would not be an occasion of charge. If the termination of the life tenant's interest was in favour of his spouse/civil partner, it would be covered by the spouse/civil partner exemption and would be exempt.

On the death of the life tenant the property was aggregated with his free estate and IHT at 40% paid on any excess over the nil-rate band. The total tax due would be split proportionally between the free estate (the responsibility of the testator's personal representatives) and the trust (the responsibility of the trustees). For CGT purposes death did not give rise to a charge but the assets within the trust benefited from a base cost uplift to market value on death.

b) Accumulation and Maintenance trusts

This is a hybrid trust introduced by a Labour government in the 1970s and was designed to give favourable IHT treatment to settlements created to provide for the maintenance of minors, and encourage (or at least allow for) gifts during their minority.

For a trust to qualify as an A&M trust the following conditions had to be met:

(i) at or before the age of 25, one or more of the beneficiaries had to take at least a life interest in the property, and

(ii) during their minority, the income was either accumulated or applied for the maintenance, education or benefit of the beneficiaries, and

(iii) the trust either has a life span of only 25 years, or all beneficiaries share a common grandparent or are the issue, widows or widowers of such grandchildren.

Gifts into a qualifying A&M Settlement were PETs. There was no IHT to pay if a beneficiary died before his interest under the trust vested. There was also no IHT to pay when either the IIP arose or the assets absolutely vested in the beneficiaries. When the IIP came into being, the trust, or fund, would be treated as described above.

c) Discretionary trusts

These are flexible trusts. Beneficiaries have neither an entitlement to the income nor the capital of the trust. As such it would be inappropriate to include the value of the trust property in the estate of any beneficiary. Equally it is understandable that the Treasury found it unacceptable to allow property to be settled in such a trust without recurrent liability to IHT, and the relevant property regime was created accordingly.

The aim was to introduce a set of rules that broadly subject property held in discretionary trusts to the same level of IHT over a lifetime as if the property had been given to an individual. This was done by imposing:

i) a lifetime transfer charge, of half the IHT rate on death, on the initial transfer, and

ii) exit charges where property leaves the settlement, and

iii) a charge (the decennial charge) every ten years on the value of the assets within the trust.

The lifetime charge (being half of the death rate) results in an effective rate of up to 20%. (Tax will not be levied to the extent that the value of the gift is covered by any unutilised portion of the nil-rate band, annual exemptions or other reliefs such as business property relief). Currently the maximum rate that the exit and decennial charges can be levied at is 6%. The exact percentage depends on the period that the property has been within the trust and the extent to which the nil-rate band has been utilised.

The death of a beneficiary is irrelevant from an IHT point of view and there is no CGT base cost uplift on such a death.

The IHT rules that apply to discretionary trusts are unchanged by the Finance Act 2006. The relevant property rules are extended, with the effect that (unless the legislation specifically provides otherwise) they apply to all new trusts created on or after 22 March 2006.

3. INTER-VIVOS TRUSTS CREATED ON OR AFTER 22 MARCH 2006

a) Interest in Possession trusts

For tax purposes, where the trust does not arise under a will or intestacy, it will be irrelevant whether a new trust confers a life interest or is discretionary. Gifts into trust will be chargeable transfers, potentially subject to IHT at lifetime rates and there will be exit and decennial charges as described in 2c above. The usual allowances and reliefs will apply. As such, if the settlor has not utilised his nil-rate band within the previous seven years, a gift up to the nil-rate band can be made without incurring a tax liability, with any excess being taxed at 20%. Annual exemptions can reduce the value of the gift, as can the allowances for gifts on marriage. Of course, the gift will form part of the settlor's cumulative transfers if further gifts are made, or he dies within seven years, and death within five years will increase the tax payable.

Business and Agricultural Property Relief will also be available if the assets, and period of ownership, qualify.

An IIP trust will no longer be treated as if the life tenant owned the trust assets. Consequently, there will be an IHT charge on the gifts (in excess of the nil-rate band) into settlement in exactly the same way as into a discretionary trust The spouse/civil partner exemption will not be available to cover lifetime gifts into a trust of which the settlor's spouse/civil partner is the life tenant.

The death of the life tenant will be irrelevant for IHT purposes, since the assets of a new trust will no longer be viewed as beneficially belonging to the life tenant.

A trust created by the settlor for himself will also be caught by the gift with reservation of benefit (GROB) rules (see section 8).

Since the creation of an inter-vivos settlement of any description will now be a chargeable lifetime transfer, CGT holdover relief will be available, apart from transfers into

settlor-interested trusts (where the settlor, his spouse or a minor unmarried child of the settlor has an interest). Previously CGT holdover relief was only available when business assets were gifted (and the trust was not one in which the settlor or spouse was interested).

The death of a beneficiary will only be relevant for CGT if it triggers the vesting of the trust property in the remainderman. In such cases trust property will cease to be held in trust and there will be a deemed disposal. There will be no CGT uplift on the death of a life tenant, as was previously the case.

Trust property will no longer be aggregated with the free estate of the settlor. This means that for valuation purposes, where the settlor owns shares personally and a trust in which he has an IIP also owns shares in the same property, the life tenant's personal holding can be valued in isolation, since the related property valuation rules do not currently apply in this situation. As such, where someone intends to increase his stake in a company, and the increased size of the holding may cause an increase in the value of the existing holding (and Business Property Relief does not apply), it might make sense for a trust to acquire the shares (even if settlor-interested for CGT) rather than the individual doing so in a personal capacity.

b) Trusts for Disabled Beneficiaries

An exception to the rules in 3a is for trusts for disabled beneficiaries.

The definition of a disabled beneficiary is strict and only applies to an individual who is:

(i) incapable, by reason of mental disorder, of administering his property or managing his affairs, or

(ii) in receipt of an attendance allowance under section 64 of the Social Security Contributions and Benefits Act 1992 or section 64 of the Social Security Contributions and Benefits (Northern Ireland) Act 1992, or

(iii) in receipt of a disability living allowance under section 71 of the Social Security Contributions and Benefits Act 1992 or section 71 of the Social Security Contributions and Benefits (Northern Ireland) Act 1992 by virtue of entitlement to the care component at the highest or middle rate.

Requirements (ii) and (iii) have been relaxed such that beneficiaries will still qualify in the following circumstances:

- if they would have been in receipt of the allowances mentioned but for being provided with certain accommodation (such as when hospitalised)
- if they would have been in receipt of the allowances mentioned but for the fact that they are living outside the UK.

The test of disability is undertaken when the property is transferred into the settlement. If the beneficiary satisfies the test, the settlement qualifies as a disabled trust even if the person should recover or the disability cease.

To qualify as a disabled beneficiary, the individual has to be severely disabled. For example, mental disorder is defined as mental illness, arrested or incomplete development of mind, psychopathic disorder and any other disorder or disability of mind. To be eligible for either of the allowances in conditions (ii) and (iii) the individual would have to require prolonged or repeated attendance during the day or night, either in connection with his normal bodily functions or to stop the individual being a danger to either himself or others. These severely restricted definitions have been retained despite opposition attempts to widen them in Committee and debate, and in the face of concerted lobbying from interest groups for the disabled.

Before the Budget changes there was no need to have special rules for an IIP trust for a disabled person, as any gift into a IIP trust was a PET. There were, however, special rules for a discretionary trust for a disabled beneficiary. The special rules for a discretionary disabled trust are unchanged. The trust has to be such that:

(i) during the life of a disabled person, no IIP in the settled property subsists, and

(ii) not less than half of the settled property which is applied during his lifetime is applied for his benefit.

The rules ensure that after 22 March 2006, an inter-vivos gift into such a trust is a PET. The disabled beneficiary is deemed to have a beneficial interest in the assets of the trust and on his death the trust assets are aggregated with his estate and IHT charged on the aggregate total above the unutilised nil-rate band. There is, however, no provision for a CGT uplift on the death of the disabled beneficiary as there is merely a deemed beneficial interest.

IIP trusts for qualifying disabled beneficiaries remain outside the new rules whether settled by a third party or by the disabled person himself. Lifetime gifts to such trusts will continue to be PETs, there will be no exit or principal charges and the trust assets will be seen as beneficially belonging to the beneficiary with the resulting aggregation of the free estate and trust property on death. In this case there is an actual beneficial interest in the trust property, so there will be a CGT uplift on the death of the disabled beneficiary.

One further category has been introduced, to allow for a self-settlement by a person with a condition that is expected to lead to a qualifying disability. This, for example, would apply to someone in the first stages of a degenerative disease.

Provided certain conditions are met, a qualifying individual can settle property on trust for himself and there will be no initial tax charge, exit charges or principal charges as apply to all other forms of self-settlement. The settlement can be into either a special discretionary or an IIP settlement. For a discretionary trust to qualify, the trust must comply with the conditions set out above for a disabled person's discretionary settlement. Furthermore, if the trust can be terminated in the settlor's lifetime the assets must vest absolutely in an individual (not necessarily the settlor) or be

held on a different type of disabled person's trust. Where the trust is discretionary there will be no CGT uplift on the death of the disabled beneficiary. For an IIP trust to qualify, the trust deed must provide that any application of trust property during the lifetime of the qualifying beneficiary is applied for his benefit alone.

However, HMRC has to be satisfied that the settlor's condition is such that it will lead to a qualifying disability. This may be a highly sensitive issue - for example in the case of incipient Alzheimers.

There is considerable disquiet with these rules and a widespread feeling that they do not go far enough to protect the vulnerable. The conditions to be met are strict and there will be many people who would benefit from having assets put within a trust rather than gifted to them absolutely who will not qualify, or will not wish to admit to a degenerative condition.

Some individuals, whilst they could not fulfil the required conditions for incapacity, may still in most people's estimation be incapable of managing finances reliably or may be vulnerable. Individuals suffering from drug addiction, bipolar disorder or schizophrenia would not be covered, for example. If given a large sum of money to hold absolutely there would be a danger of its being squandered, a trust would provide protection. Previously, they could be given an IIP in the income while the underlying capital remained protected. This can now only be advanced if gifts are made within the settlor's nil-rate band, or the IHT cost is accepted.

c) A&M trusts

A&M trusts will no longer enjoy favoured status if created after 22 March 2006. There is nothing preventing such trusts being set up but they will be taxed in accordance with the relevant property regime. There will be a potential immediate IHT charge (at a maximum rate of 20% on the value of the gift if there is no nil-rate band or annual exemption to utilise) and exit and principal charges as described above.

4. TRUSTS CREATED ON OR AFTER 22 MARCH 2006 ARISING ON DEATH

There are no changes to the tax treatment of discretionary trusts created in a will. As such, ensuring that both spouses'/ civil partners' nil-rate bands are utilised through a discretionary trust designed to hold the testator's remaining nil-rate band is still basic IHT planning.

Trusts for disabled beneficiaries (which meet the tests in 3b above), which are created on death will not be subject to the relevant property regime of exit and principal charges. As with disabled trusts created during the lifetime of the settlor the disabled beneficiary will be treated as being beneficially entitled to the trust property with the consequences described above.

Three new types of trust have been created by the new legislation. These are:

- Immediate post death interest trusts (IPDI)
- Trusts for bereaved minors (TBMs)
- Age 18-25 trusts

Will trusts that fall within these provisions will not be subject to the discretionary trust regime.

It is important to realise that the three new types of trust described above apply **only** where the beneficiary's entitlement arises on the will or intestacy of the deceased, and not to new inter-vivos settlements, nor to existing trusts, which are dealt with by the transitional provisions described later.

a) Immediate Post-Death Interest trusts

The initial draft legislation covering immediate post-death interest trusts (IPDI) was highly restrictive in the conditions applied. The spouse/civil partner exemption would not have been available in the case of a will trust incorporating powers of revocation or appointment (other than exercisable by the spouse).

Fortunately, following representations by the professional bodies, these restrictions have been deleted. Ironically, this leaves open the possibility of lifetime transfers deemed to be effected by the surviving spouse, although if the property remains on trust the deemed transfer will be chargeable at the lifetime IHT rate (if it exceeds the spouse's nil-rate band) rather than treated as a PET.

The old rules that applied to IIP trusts (as explained in 2a) will apply to IPDI trusts. That is, no exit charge on property passing to a life tenant and aggregation of the trust property with the beneficiary's free estate on death. For CGT purposes, the death of the life tenant will not give rise to chargeable gains accruing on trust property, and there will be a CGT base cost uplift.

The IHT consequences of a termination of the life tenant's IPDI during his or her lifetime depend on what happens to the trust property. The termination will qualify as a PET in the following situations:

(i) if the trust property is absolutely vested in an individual, or

(ii) if there is a gift into a disabled person's trust or a life interest trust for a qualifying disabled person, or

(iii) if the initial trust was established under the will of a parent **and** the IPDI is terminated and replaced by a bereaved minor's interest.

In all other circumstances it will be a chargeable transfer with the potential for IHT at 20% (increasing if the life tenant does not survive five years) depending on allowable reliefs and the extent to which he has utilised his nil-rate band within the past seven years.

The way the legislation is drafted, an IPDI would not be created by a gift into an existing IIP trust. The legislation requires the settlement to be effected on death (by will or intestacy) and the life interest to arise at the time. If the trust already exists then - arguably - neither condition can be met. The exercise of a power of appointment over property within an existing settlement by a testator in his will may also not be sufficient to create an IPDI. Opinions differ in this area, on the grounds that HMRC otherwise regard additions by new settlors to constitute separate IHT settlements, and so it is felt arguable that an IPDI has been created within an existing trust. However, it is important to review wills and it would be preferable to ensure that new trusts are created rather than utilising existing trust structures.

Example

In the common case of a deceased husband's will providing an IIP for his widow to be terminated in the event of her re-marriage in favour of his children, there would be no IHT on death as the transfer would be exempt by virtue of the spouse/civil partner exemption. If the assets vest absolutely in the children, the termination of the life interest will be a PET.

Should, however, the terms of the trust be such that on the spouse/civil partner's remarriage, her life interest is terminated in favour of enduring trusts for the children, the IHT consequences will be quite different. To re-cap, a termination will only qualify as a PET:

(i) if the trust property is absolutely vested in an individual, or

(ii) if there is a gift into a disabled person's trust or a life interest trust for a qualifying disabled person, or

(iii) if the initial trust was established under the will of a parent and the IPDI is terminated and replaced by a bereaved minor's interest.

The termination will not qualify as a PET if children do not immediately take an absolute interest and the interest is not being terminated in favour of a trust for bereaved minors (summarised below). While the settlement is established in the will of the deceased parent, the age qualification (that beneficiaries must take absolutely at 18) is met. As such there will be a chargeable transfer (with the potential for a 20% IHT charge on the value of the trust property dependent on the amount of nil-rate band available to set off against the transfer and the availability of IHT reliefs such as that for business property). Going forward the trust will be subject to exit charges and the decennial charge. The age 18-25 trust regime is not applicable here even though the trust was established by the will of the children's father, because the trust terms do not provide for the children to become absolutely entitled to the settled property at the age of 25 (but merely give an IIP).

Successive Life Interests

Happily, amendments at Report stage have established a special transitional protection for pre-22 March 2006 trusts where the spouse becomes entitled to a successive life interest on the death of the life tenant (see 5b below).

For trusts created on or after 22 March 2006, a successive life interest for the surviving spouse/civil partner will neither be an IPDI, nor benefit from the transitional exemption. While the surviving spouse/civil partner will become beneficially entitled to the interest on the death of the life tenant, the trust would not have been created by the life tenant's will and therefore the conditions necessary to establish an IPDI are not met. Not only will the spouse/civil partner exemption not apply to the trust property when calculating the IHT payable on the death of the husband, but going forward the trust will be subject to exit and decennial charges. As such, there will need to be careful consideration before providing successive life interests in trusts created on or after 22 March 2006.

Related Property

Initially, the way the legislation was drafted meant that all IIP trusts created on death on or after 22 March 2006 would constitute related property and be taken into account in calculating periodic and exit charges for trusts created at the same time and subject to the relevant property regime.

Previously, where a trust was created for the settlor or his spouse/civil partner, for tax purposes the date of the settlement was deemed to be the date that the later life interest of the settlor or his spouse/civil partner ended and not the actual date the trust was created. This meant that if a will established a nil-rate band discretionary trust and an IIP for the spouse in the remainder of the estate, the IIP for the spouse was not related property and was, therefore, ignored when looking at the IHT position of the nil-rate band discretionary trust.

Government amendments have preserved the pre-22 March 2006 position where the spouse/civil partner has an IPDI or a disabled person's interest, and the example in the paragraph above will hold true whether the testator dies before or after 22 March 2006.

b) Trusts for Bereaved Minors

Such trusts can only be established:

(i) on intestacy where statutory trusts are created for the benefit of the bereaved minor, or

(ii) under the will or on the intestacy of a deceased parent, or

(iii) under the Criminal Compensation Scheme.

The term 'parent' includes step-parent. It also includes any person who has parental responsibility for the minor. For England and Wales the definition of parental responsibility is taken from Children Act 1989 and can cover:

- Natural parents
- Adopted parents
- Step-parents
- Legal guardians
- A person to whom the courts have granted a residency order with respect to the minor.

A grandparent would only qualify where he had been appointed as the child's legal guardian or a residency order is in force.

The tax favoured status of such a settlement would not extend to funds added after creation. There was extensive lobbying on this point but the Government would not give way.

For a trust to qualify, the terms of the trust deed must be such that by the age of 18 the bereaved minor will become absolutely entitled to the settled property, the income arising from it and any accumulated income. The initial trust can be either life interest or discretionary.

While the beneficiary is under 18 the following conditions must be met:

(i) all property advanced from the trust is advanced to or for the benefit of the bereaved minor, and

(ii) the bereaved minor is or will become (at 18) entitled to any accumulated income which has arisen from the settled property, along with the settled property itself, and

(iii) no income is applied for the benefit of any other person.

The legislation allows a trust to qualify even if the trust deed gives the trustees a modified power of advancement such that they could advance property to someone other than the bereaved minor. As such, if the beneficiary at age 17 is giving cause for concern, the trustees could make a settled advance to give him a life interest rather than letting him have the trust property at 18. There would not be an IHT charge on the gift but the new trust would be within the relevant property regime and so subject to exit and decennial charges.

Such trusts will not be as flexible as under the A&M trust regime. Where there is more than one beneficiary, it will no longer be possible for the trustees to have the discretion to pay income to whichever beneficiary they decide, or to vary the shares of the beneficiaries. The trust accounting records should be such that each beneficiary's share of income is clear and any income not advanced during his minority can be paid to him when he reaches 18.

Trusts for bereaved minors are not subject to the exit and decennial charges. There is no charge to IHT when the beneficiary becomes absolutely entitled to the trust assets at 18. An immediate charge to CGT can be avoided by claiming holdover relief. Depending on whether the trust has brought-forward capital losses and its taper relief position, this might not be appropriate in all cases but often such a claim may be helpful.

Should the beneficiary die before reaching 18 there will be no charge to IHT and no disposal for CGT.

There is a claw-back charge to IHT if assets are appointed to an ineligible beneficiary. The charge is identical to that which applies for A&M settlements. Provided proper advice is taken, this should not occur.

Trusts for minors (whether TBMs or 18 to 25 trusts) where a beneficiary entitled to an IIP dies under 18, will benefit from a tax free CGT uplift.

c) Age 18 to 25 trusts

It seems to be acknowledged in all but Government circles, that giving significant sums of money to those under 25 is not always appropriate and the provisions for bereaved minors were felt to be inadequate.

Extensive representations were made, which resulted in an amendment to create a new category of IHT favoured trust. Instead of amending or modifying the rules for bereaved minors' trusts, a new code was introduced as an appendix to the bereaved minors' regime. The crucial difference between the categories is that in this case the beneficiary does not have to take an absolute interest at 18, and a trust will qualify provided that the absolute interest is deferred no later than the age of 25.

There will be no exit or decennial charges while the beneficiary is under 18. Where the beneficiary takes an absolute interest at 18 there will be no IHT, just as there will be no IHT if he dies under the age of 18. All these provisions mirror the bereaved minors' regime.

Between the ages of 18 and 25, a reduced IHT charge will apply on the death of the beneficiary, on the advancement of capital and on absolute vesting of the trust assets. The tax will be payable on the occurrence of the relevant event and will be calculated in the same way as an exit charge from a discretionary trust.

The maximum period the charge can apply to is seven years and the maximum rate of tax payable will be 4.2%. Many parents may decide that a tax charge of 4.2% is a price worth paying to safeguard the underlying trust assets while their children mature. It does, however, seem unfair that such a charge is imposed when the reason for delaying the absolute vesting of the assets is not tax avoidance but prudence, a virtue that the Chancellor used to profess to espouse.

As with a trust for a bereaved minor, CGT holdover relief will be available on a beneficiary's becoming absolutely entitled, and there is a claw back charge to IHT if assets are appointed to an ineligible beneficiary.

5. TRANSITIONAL PROVISIONS FOR TRUSTS CREATED PRIOR TO 22 MARCH 2006

There are transitional provisions applying to:

- Existing IIP trusts, (and protective trusts).
- IIP trusts with a successive life interest to spouse/civil partner.
- A&M trusts.
- Contracts of life assurance held within IIP or A&M trusts.

a) Transitional provisions applying to IIP trusts

The pre-22 March 2006 IHT treatment of trusts is preserved in the following circumstances:

- Where, in respect of a life interest existing on 22 March 2006, the life tenant in place on 22 March 2006 retains his pre-Budget Day beneficial interest in the income of the trust.
- Where a transitional serial interest (TSI) has been created.

Such an interest can only be established in the period between 22 March 2006 and 6 April 2008 and the following conditions must be met:

i) the settlement must have been created before 22 March 2006, and

ii) as at 21 March 2006, the settlement must have been a life interest trust, and

iii) the current beneficiary (B) became entitled to his life interest on the coming to an end of the interest of the life tenant (P) as at 21 March 2006, and

iv) B becomes beneficially entitled to the current interest at the changeover date.

Where the pre-22 March 2006 life tenant remains in place or a TSI is established, the old rules for IIP trusts (as explained in 2a) will apply. There will be no exit or decennial charges and the trust property will be aggregated with the beneficiary's free estate on death. For CGT purposes the death of the life tenant will not give rise to chargeable gains accruing on trust property, and the trust property will continue to be rebased.

The termination of an IIP and the creation of a TSI during the original life tenant's lifetime will be a PET, or exempt if the termination is in favour of the spouse/civil partner. This is because the new life tenant will continue to be treated as being beneficially entitled to the trust property. For the same reason, if a TSI is created on death and the new life tenant is the spouse/civil partner of the previous life tenant then the spouse/civil partner exemption will still be available.

A TSI can be created passively or actively. Examples of an interest created passively would be:

- On the death of the pre-22 March 2006 life tenant, where the terms of the trust provide for a successive life interest.
- Where the life tenant's interest is revoked as a consequence of the terms of the will; for example, through a condition that should the surviving spouse/civil partner remarry her life interest would be revoked, in favour of a successive life interest to another.

In the cases above there has been no intention to create a TSI: it has arisen as a result of events.

Provided the trust deed provides the flexibility, it is likely that there will be a significant number of cases where the trustees may resolve to accelerate the succeeding life interest so that the trust remains within the old rules for as long as possible and the exit and decennial charges are avoided. In many cases this will represent good tax planning but it is important to review each case on its merits. Accelerating a life interest so that a person in poorer health than the existing life tenant takes a TSI would be counter-productive for IHT planning, but CGT rebasing would be available on the assets representing the interest terminated.

The way the legislation is worded implies that a TSI can only arise once, on the changeover between the pre-22 March 2006 tenant's interest and the replacement life interest. As a result it is vital that no change is made without very careful consideration. Trustees should keep in mind events that will revoke the pre-22 March 2006 life interest, and whether the default life tenant provided by the trust deed is the most appropriate person to take the TSI.

The legislation appears to require the entire beneficial interest of the pre-22 March 2006 life tenant to be terminated in order for a TSI to be created. The termination of a proportion of the pre-22 March 2006 beneficiary's life interest would not qualify, such a termination being a chargeable lifetime transfer. Tax at lifetime rates would be payable on the value of the gift in excess of the individual's unused nil-rate band. The trust property in which the successive life interest subsisted would also be subject to the exit and decennial charges.

It would, however, appear that the original interest can be replaced by more than one interest, provided the changes occur simultaneously and the whole of the pre-22 March 2006 interest is transferred. Thus a parent's pre-22 March 2006 interest can be terminated in favour of separate IIPs for each of his children.

Protective trusts

Protective trusts are hybrids designed to provide protection for and against a spendthrift beneficiary or, perhaps, a beneficiary engaged in a risky business venture. An initial IIP for the beneficiary (B) would be determined automatically upon B's bankruptcy or attempted alienation of the life interest. In the event of a determination of B's life interest, the trust would then be held on discretionary trust - usually

for B, his spouse/civil partner, children and grandchildren. The determination of B's IIP and its replacement by the discretionary trust triggers the protective trusts.

Before 22 March 2006, such an event did not change the way the trust was treated for IHT purposes. This is because for IHT purposes B was still seen as beneficially entitled to an IIP in all the trust property.

The transitional provisions specifically provide for protective trusts, with the result that transitional protection will not be lost if after 22 March 2006 the protective trusts are triggered. For IHT purposes, B will still be seen as beneficially entitled to the trust's assets.

It may not be possible to replace the life tenant of a protective trust with a new life tenant (and so create a TSI), as such a move might trigger the protective trusts. Should this be attempted, the action will not (because of the provision referred to) forfeit the transitional protection, although it may result in a discretionary trust coming into being with the resulting income tax consequences and a loss of CGT base cost uplift on the death of the life tenant.

The special treatment for protective trusts will only be available to new trusts created on or after 22 March 2006 if they meet the IPDI conditions or where the underlying interest is a qualifying disabled person's interest.

b) IIP Trusts with Successive Life Interest to Spouse/Civil Partner

This is a special TSI covering the period after 6 April 2008 (everything before that date being covered by the standard transitional provisions).

For this special transitional provision to apply:

(i) the trust must have been created pre-22 March 2006, and

(ii) the pre-22 March 2006 life tenant's interest comes to an end on death, on or after 6 April 2008, and

(iii) the life tenant of the trust pre-22 March 2006 must be the spouse/civil partner of the person entitled to the successive life interest on his death.

Where the above conditions are satisfied the spouse/civil partner exemption will be available on death and the trust will not fall within the relevant property rules.

Example

A trust deed provides for a life interest to a surviving spouse to be revoked on re-marriage in favour of a life interest for the son, and on his death for his spouse (with remainder to their children). The trust was created pre-22 March 2006 and the widow is now about to marry again - before 6 April 2008 but the son is in ill health. The trustees could terminate the spouse's interest before the re-marriage and appoint the life interest to the son's wife. The termination of the spouse's life interest is a PET, whether it is the son who succeeds to a life interest, or the daughter-in-law. By appointing the life interest to the son's spouse rather than letting events take their course, the following may be achieved:

- An IHT saving on the death of the son as the property does not pass through his estate.
- By ensuring the son's spouse has the TSI the trust can remain within the old rules throughout her life.

In this case the special TSI for successive life interests in favour of a spouse/civil partner would not otherwise offer protection as the son was not the life tenant on 21 March 2006.

c) Transitional Provisions applying to A&M trusts

The transitional provisions as they apply to A&M trusts are significantly less favourable than for IIP trusts. Unlike IIP trusts, most pre-22 March 2006 A&M trusts will not be able to continue under the old regime without making changes to their terms.

There is a two-year period of grace until 6 April 2008. A&M trusts which provide for property to vest absolutely in beneficiaries at 18 can remain unchanged, with no charge to IHT if the beneficiary dies under the age of 18 and no IHT charge when the beneficiary takes the assets on reaching 18.

The trustees of all other A&M trusts will have to make decisions. If the trustees are prepared and able to amend the provisions of the trust before 6 April 2008, so that beneficiaries take absolutely at 18, then these trusts too will be outside the relevant property regime. Trusts which are not changed so as to provide that trust property vests absolutely at 18 will be subject to the relevant property regime, but will not incur any initial charge on becoming subject to the new rules.

Following representations from the professional bodies, pre-22 March 2006 A&M trusts whose deeds allow (or can be amended before 6 April 2008 to allow) the trust property to vest absolutely at or before the age of 25 will only be subject to the relevant property regime from the beneficiary's 18th birthday. As with age 18-25 trusts described in 4c above, there will be an IHT charge on the following events:

(i) the death of the beneficiary, and/or

(ii) advances of trust capital to the beneficiary between 18-25, and/or

(iii) trust property absolutely vesting in the beneficiary between 18-25.

The IHT charge will be calculated in exactly the same way as the charge with respect to 18-25 trusts and the maximum possible tax charge, which will occur where assets vest absolutely in the beneficiary at 25, is currently 4.2% of the value of the assets. As there will be a chargeable event for IHT purposes, CGT holdover relief will be available where assets pregnant with gains are transferred to a beneficiary.

From 6 April 2008 any A&M trust whose terms do not, or have not been amended to, provide for trust property to vest absolutely by the time the beneficiary reaches 25 will be subject to the relevant property regime.

The decennial charge (which falls on each ten year anniversary) applies only if such an anniversary occurs after 6 April 2008. So, the first date on which the decennial charge will apply for an A&M trust set up on 17 May 1998, which is not covered by the reliefs above, is 17 May 2008. If the trust had been created on 17 May 1997 the first decennial charge would fall on 17 May 2017. In either case the trust property will only have been relevant property from 6 April 2008 and so the first charge will run from that date to the next ten year anniversary.

Most pre-22 March 2006 A&M trusts will not provide for assets to vest absolutely when the beneficiaries reach 18 and many provide for an IIP - rather than absolute vesting - at age 25; although in many cases there may be power to appoint or accelerate capital vesting at that age.

Many Trustees will now have to decide whether to incur IHT charges by adhering to the original intentions for the trust, or to avoid or mitigate the IHT by altering the terms and accelerating absolute interests. In many cases, trustees may reflect that the relevant property regime, with a decennial charge, is preferable to advancing assets absolutely to a young beneficiary, and passing over control of substantial wealth.

Where a beneficiary is to become entitled to an IIP in the transitional period, any decision to advance absolute vesting should be taken before the interest vests.

Example

An A&M trust was set up on 25 October 2000 for the grandchildren of the settlor, the terms of which are that the children take an IIP at age 25 with the remainder to their children. On 22 March 2006 there are four beneficiaries: A who is 30, B who is 24, C who is 17 and D who is 7.

A has a pre-22 March 2006 IIP and as such is covered by the rules explained above in 5a. As such there will be no IHT charges during his life tenancy, on his death the trust property will be aggregated with his free estate, and assets will be rebased for CGT purposes on his death.

B will take an IIP during the transitional period. There was not, however, a pre-22 March IIP in his share of the trust, and as such he will not come within the TSI provisions. Therefore he will not take a qualifying IIP, and, unless the rules of the trust are changed before he reaches 25 so that he receives his share absolutely no later than that age (as opposed to a life interest), his fund will be subject to the relevant property regime and the first decennial charge will be on 25 October 2010.

Unless the terms of the trust are amended, the relevant property regime will apply from 6 April 2008 to C and D's shares of the trust property. Whatever happens, there will be no IHT charge when C reaches 18 as this is before 6 April 2008. If the terms are amended before 6 April 2008, so that the beneficiaries take the property absolutely at 18, there will be no IHT charges. As the beneficiaries would then take their entitlement to income and capital at the same time, CGT holdover relief will also be available when the trust assets are vested in C and D.

If the trust rules are changed so that C and D take absolutely at 25 then there will be an IHT charge with respect to C for the period from 6 April 2008 (as he is already 18 at that date) to his 25th birthday. The IHT charge for D will cover the seven years from his 18th to his 25th birthday. CGT holdover relief will be available when the assets are transferred to the beneficiaries.

d) Transitional provisions applying to life contract policies

Life contract policies settled in IIP trusts benefit from enhanced transitional provisions which create a special TSI where the following conditions are met:

(i) a pre-22 March 2006 IIP trust consists of, or includes, a contract of life assurance, and

(ii) the beneficial rights of the life tenant as at 21 March 2006 come to an end on death after 6 April 2008 (the period before then being covered by the normal TSI provisions explained in 5a above), and

(iii) the rights of the current life tenant arose on the death of the life tenant as at 21 March 2006 or the death of a subsequent life tenant, provided that each life tenant succeeded to the previous life tenant's interest on death, and there is an unbroken chain of life interests arising on death stretching back to the life tenant on 21 March 2006.

This special TSI can only arise on the death of the previous life tenant. A change of beneficiary after 6 April 2008 for any other reason will not be covered.

The amended legislation specifically allows premiums to be paid after 22 March 2006 and the trust will continue to benefit from its protected status. The contract can also be varied, provided the variation is allowed under the terms of the pre-22 March 2006 policy contract. Post-Budget premiums paid will either be PETs, or exempt as normal expenditure out of income.

Life contract policies settled into trust on or after 22 March 2006 will be subject to the relevant property regime. There will rarely be an initial charge as the policy will be placed on trust very soon after it has been created and in most cases will be of little or no value. The value on each ten year anniversary will depend on the life expectancy of the person whose life is insured. Where the life insured is relatively young and in good health the policy will be worth very little. If, however, the insured is old or has health problems, the valuation could be quite high.

6. ADDITIONS TO PRE-22 MARCH 2006 TRUSTS

There are no provisions in the Finance Act dealing with additions.

An additional gift into a trust on or after 22 March 2006 will be a chargeable lifetime transfer unless it is a gift into a disabled person's trust. HMRC's view is that the additions to existing trusts should be treated as new settlements, subject to the relevant property regime of exit and decennial charges. This view is not universally shared and has been questioned by some within the profession.

7. DEEDS OF VARIATION

The legislation specifically provides that where a deed of variation is entered into within two years of the death of the deceased, any settlement created by the deed will be treated as if it has been included in the will of the deceased. As such, a deed of variation can establish an IPDI, a trust for the benefit of a bereaved minor or an age 18-25 trust.

This relief will only apply where, in the period between the death and variation, no IPDI or disabled person's interest has subsisted in the property.

Where the death occurred before 22 March 2006 there is a further condition that no other IIP subsisted in the property during the period between death and variation.

8. GIFTS WITH RESERVATION OF BENEFIT

The legislation extends the gift with reservation (GROB) provisions. There will be a GROB when a life tenant's interest is terminated but he retains a benefit in the settled property and either:

(i) the trust is a pre-22 March 2006 IIP settlement, or

(ii) an IIP trust is created on or after 22 March 2006, and the IIP is an IPDI, a disabled person's interest or a TSI.

A life tenant retaining a benefit in or from trust property after his IIP has terminated during his lifetime will be treated in the same way as a donor making a GROB. Tracing provisions mean that the GROB provisions will apply where the original property has been replaced with other assets in which the former life tenant has retained a benefit.

Where a will trust creates a flexible life interest for the spouse and the spouse's interest is terminated in favour of a discretionary trust of which he or she is a beneficiary, the spouse will now be caught by the GROB provisions. This is a long-anticipated measure. To avoid this, the former life tenant would have to be excluded from any future benefit.

As trust property within an IIP settlement created on or after 22 March 2006 will no longer be deemed to be within the life tenant's estate on death, there will be a GROB where a settlor creates a life interest trust for himself.

Where there is a trust for the settlor or his spouse and the GROB rules are not in point, the pre-owned asset tax could be an issue. The situation will need to be reviewed carefully.

Foreign property settled by a non-UK domiciled settlor where the settlor reserves a benefit will be excluded property even if the settlor becomes UK domiciled before death. It appears still to be accepted by HMRC that the excluded property provisions over-ride the GROB rules, but the Revenue Manuals have appeared ambiguous on this score for several years, and the position may be contested in the future.

9. PRE-OWNED ASSET TAX

One of the crucial exemptions from the pre-owned asset tax is where the property (or property which derives its value from that property) is retained within the estate of the tax-payer. As such there was an exemption for property held on IIP terms, consistent with pre-22 March 2006 IIP rules deeming such property to belong to the life tenant and aggregating it with his estate on death.

For settlements created on or after 22 March 2006 this will not be the case as the property will not be deemed to be part of the life tenant's estate. Therefore, where the GROB rules would not otherwise catch the settlor (thereby exempting him from the pre-owned asset tax charge), a liability to pre-owned asset tax could arise.

10. THE REVERTER TO SETTLOR PROVISIONS

For trusts created on or after 22 March 2006, provisions exempting from tax property which reverts to the settlor or his spouse/civil partner, will only apply to a disabled person's interest trust or a TSI trust. There is a special provision allowing for non aggregation in the case of an IPDI trust, where the property reverts to the settlor's widow or surviving civil partner within two years.

Existing trusts which revert to the settlor should be reviewed to ensure the exemption has not been negated by the Finance Act changes. For the exemption to continue to be available, the settlor will, unless disabled, have to take an absolute interest on a reversion.

11. NON-DOMICILIARIES AND EXCLUDED PROPERTY TRUSTS

a) The general concept of domicile

Domicile remains an important concept for UK tax purposes (and for many non tax purposes). It determines the scope of UK tax with regard to an individual's foreign income and assets. An individual neither domiciled nor deemed

domiciled within the UK is subject to IHT only on assets situated in the UK. Similarly the Pre-Owned Asset Tax only applies to UK assets of foreign domiciliaries. Individuals domiciled, or deemed domiciled, within the UK are subject to IHT and the Pre-Owned Asset Tax charge on their worldwide assets.

Domicile is a concept of UK private international law, which has been adopted for UK tax law, and should not be confused with the meaning of domicile in common usage, or foreign equivalents.

The rules are complex and a summary is beyond the scope of this briefing note. However, for IHT purposes, in addition to the general rules for determining an individual's domicile, it is provided that someone will be deemed domiciled within the UK if:

(i) he has been residing in the UK for 17 out of the 20 years of assessment ending with the year in which any chargeable event took place, or

(ii) he has been domiciled in the UK but has ceased to be resident and established a domicile of choice elsewhere. He will be deemed domiciled within the UK for three calendar years from the date that he lost or changed that UK domicile.

In most circumstances it will be the first test which will be most difficult to avoid and an individual will have to spend four complete tax years as a non-UK resident before he will lose his deemed UK domicile.

b) Excluded property

Certain property is excluded from IHT, in particular, foreign assets owned by an individual who is neither domiciled nor deemed domiciled in the UK.

Separate rules apply to determine whether property within a trust qualifies as excluded property. To do so:

(i) the property comprised in the settlement must be situated outside the UK, and

(ii) the settlor must have been domiciled outside of the UK at the time the settlement was made.

In the Pre-Budget Report, the Government announced steps designed to prevent tax avoidance by UK-domiciled individuals who purchase second hand interests in foreign trusts. The excluded property exemption will no longer be available where such interests have been purchased on or after 5 December 2005.

c) Initial interest of the settlor or his spouse/civil partner in an IIP trust

Before 22 March 2006, special rules applied in certain cases where on creation of a trust the settlor or his spouse/civil partner had an initial IIP in the trust property. The property was not to be treated as settled property until it (or any part of it) was held on trusts under which neither the settlor nor his spouse/civil partner had an IIP. The settlement was deemed to have been made by the party whose interest came to an end last. To qualify as excluded property, the actual settlor and the deemed settlor both had to be domiciled outside the UK, the first when the settlement was made and the second when his or her interest terminated. In practice, this only affected trusts which became discretionary in cases where the settlor or spouse had become domiciled or deemed domiciled in the UK before their IIPs terminated.

A simple way to avoid these provisions was to ensure that the settlement was initially discretionary (that is neither the settlor nor his spouse/civil partner had an initial IIP). Another was to provide successive life interests to take effect after the initial interests of the settlor or spouse so the trust funds were never subject to the discretionary regime.

Following the changes to the IHT treatment of IIP trusts (as explained above) this rule will only affect new trusts where an IIP arises as a result of an IPDI trust (see Section 4a above) or a qualifying disabled person's interest (see 3b above). It will no longer apply to inter-vivos settlements created on or after 22 March 2006. Thus it will not affect new settlements with an immediate IIP for the settlor and can only apply to one for his spouse/civil partner if the IIP is an IPDI. Consequently, where an inter-vivos settlement is made, it will only be the settlor's domicile at the date the settlement was created which is relevant to determining its status as excluded property.

Example

If, on 17 May 2006, a foreign domiciled settlor created a life interest trust of foreign situated assets for his UK domiciled wife and her life interest is terminated subsequently in favour of a life interest for her children, the trust assets will now remain excluded property. There would be a different result if the settlement had been created on 17 May 2005 as the anti-avoidance provisions would have deemed the UK domiciled wife to be the settlor and the assets within the trust would not be excluded property.

Pre-22 March trusts

Pre-22 March 2006 trusts continue to be governed by the old rules and excluded property status will be lost if the relevant individual (either the settlor or his spouse/civil partner enjoying a IIP) has become either domiciled or deemed domiciled in the UK before the initial IIP terminates. Unless the initial IIPs can be terminated beforehand, the settled property will be denied excluded property status, and subject to decennial and exit charges.

The change will have the effect of denying excluded property status to some existing trusts which relied upon serial life interests to qualify. Before 22 March 2006, a trust with successive IIPs on the expiry of the interest of the deemed settlor continued to be an excluded property settlement, even if the deemed settlor had acquired a UK domicile, because these provisions only applied to relevant property (i.e. property on discretionary trusts). With the

abolition of the IIP regime, except for TSIs, assets subject to successive interests will now be relevant property, and therefore there will be no escape from these provisions, if while the settlor, or his spouse/ civil partner enjoy initial IIPs, their domicile changes. Trustees, beneficiaries and settlors will all have to consider firstly the circumstances of the settlor and his spouse/civil partner and (if they are likely to be domiciled or deemed domiciled in the UK when their interests are expected to terminate) whether to determine their IIPs beforehand if this is possible, or accept the loss of excluded property status, or indeed to advance property absolutely from the settlement at or before the termination of the last initial interest of the settlor or spouse.

In any event, whenever settled property is enjoyed by a settlor, the GROB provisions and liability to Pre-Owned Asset Tax must be carefully considered, and specific advice taken. The situation where a donor or contributor has become domiciled or deemed domiciled within the UK is particularly complex.

12. TRUSTS IN DIVORCE CASES

When a marriage breaks down, taxation is generally the least concern. However, it is important to maximise wealth at such a time and managing the adverse tax consequences of marriage breakdown has an important role to play in this exercise.

Where both spouses are domiciled within the UK, or are both domiciled abroad, transfers of assets between spouses are exempt from IHT. The IHT exemption continues to apply until the decree absolute. After the decree absolute the transfer may still be exempt under either of the following provisions:

(i) a transfer of assets not intended to confer any gratuitous benefit. (This applies to a transfer pursuant to a court order), or

(ii) a transfer made for the maintenance of the spouse or ex-spouse. Maintenance is given a wide meaning and will cover transfers of property as well as ordinary maintenance agreements.

Before Budget Day 2006, trusts provided a way to secure the interests of children, while permitting the former spouse to enjoy the immediate benefit. Trusts were not subject to exit or principal charges and the initial transfer was either potentially exempt or exempt from IHT altogether.

Despite extensive representations, the Government has refused to relax the IHT treatment for trusts created as the result of divorce. As such, depending on the circumstance (the availability of the settlor's nil-rate band and other IHT reliefs) trusts created in these difficult circumstances could be faced with an initial lifetime charge, decennial charges and exit charges.

The Government is not minded to treat trusts created as the result of divorce any differently from lifetime trusts created in other circumstances. They believe couples should have a clean break settlement, and that using trusts on divorce is a matter of personal choice, and should not benefit from special treatment.

The Government's attitude is disappointing as trusts have proved helpful in achieving divorce settlements. The spouse with the greater wealth (A) might be resistant to the other's (B) demands, but might be prepared to compromise if assets were settled for the benefit ultimately of the children of the marriage. B might also be prepared to accept a less generous settlement if A were to provide substantial trusts for the children. A might be prepared to be significantly more generous to his or her children by B than to B personally.

Before 22 March 2006, such a settlement (giving an IIP) would have been a PET by A and there would be no decennial or exit charges. Any such settlement created after 22 March 2006 will now potentially be subject to an immediate lifetime tax charge, decennial charges and exit charges.

It has been suggested that on the positive side, a transfer of assets after 22 March 2006 would be eligible for CGT holdover relief (before 22 March 2006 such relief would only have been available if the assets qualified as business property and the trust was not settlor-interested), and so initially the overall tax liability pre and post 22 March 2006 would not be that different. Such a contention overlooks two important points:

- In the situation described above CGT holdover relief will probably not be available as it is highly likely that minor children (who have not entered into a marriage or civil partnership contract) will be beneficiaries. This being the case, CGT holdover relief will not be available (as the trust will be settlor-interested) so there will be a charge to both CGT and IHT.
- CGT holdover relief only defers the CGT charge. It provides a cash flow advantage not an absolute tax saving. (Indeed before such a claim is made it is vital to take into account the taper relief position because making such a claim could increase the overall amount of tax that will have to be paid).

The initial lifetime IHT charge is absolute and so, even if CGT holdover relief is available and the taper relief situation makes it advisable to claim it, while the initial tax liability on the creation of the trust might appear similar to that under the pre-22 March 2006 rules, the overall liability when the gain held over becomes chargeable will be significantly higher.

Where a trust is established pursuant to a court order so that the former spouse has an IIP, the initial transfer will be exempt as a transfer of assets not intended to confer gratuitous benefit. The trust will, however, be subject to decennial and exit charges. Since the trust may have been used to ensure that the assets will pass to the children and not be passed by B to any new spouse or subsequent children B might have, the pre-22 March 2006 rules would seem a fairer way of dealing with the situation.

Trust structures have also been used to hold the family home where the assets are insufficient for a court to order that the property be transferred absolutely to the spouse with whom the children are residing, and it is desirable that the sale of the home be deferred until the children reach a specified age or cease to be in full time education. One mechanism for achieving this is a Mesher Order. This can be viewed as creating a settlement, and so while the court order (not giving rise to a disposition intended to confer a gratuitous benefit) would not incur an initial IHT charge, the decennial and exit charges would still apply. To avoid such charges, rather than using a Mesher Order, it will be necessary to word the court order in such a way that the arrangement cannot be interpreted as creating a trust.

Structuring ownership of the former matrimonial home as a joint tenancy would mean that the non-resident spouse could not force a sale, and the resident spouse could postpone sale indefinitely. Any change to the home ownership structure pursuant to a court order would be exempt for IHT purposes and there would be no ongoing exit or decennial charges. However, the disadvantage is that either spouse could postpone a sale indefinitely (after the children of the marriage have grown up and left the family home) and, unless there was a restraining order of some sort, the departing spouse would still enjoy full ownership rights. For these reasons this might not be an acceptable solution.

An alternative might be a deferred charge. In this case one spouse would have full ownership of the matrimonial home but the other spouse would have a charge for either a fixed or variable amount. The spouse in occupation may feel happier knowing she has an absolute entitlement to the property and enjoys all the rights of ownership and control and it may be easier for the spouse who has left to obtain a mortgage on a new property.

The advantage of using a trust is the greater availability of the Principal Private Residence exemption (PPR) on the eventual sale. With other solutions, PPR will only be available on the share of the gain that relates to the spouse in occupation. Where a charge is created, HMRC's view is that the charge is an asset. Under the variable charge route when the property is sold, the spouse who has left will have a chargeable gain on the difference between the amount he receives and the initial value of the charge when it was created.

There will also be problems in cases where it is agreed that trustees of an existing settlement for one party should appoint a life interest in part of the fund in favour of the other party. As the spouse whose interest is reduced does not own the assets absolutely, such an event will not qualify for the IHT exemption under the provisions covering the transfer of assets not intended to confer any gratuitous benefit. Subject to the transitional provisions when a new interest is appointed prior to 6 April 2008, this will be a chargeable lifetime transfer and the relevant property regime will apply to the part of the settlement appointed onto new trusts. In this situation consideration should be given as to whether it is possible or desirable to advance property to the spouse absolutely. If the trust gave a pre-22 March 2006 IIP to the party, there will not be an immediate exit charge. If at this stage the couple is only separated and not divorced the spouse exemption will apply, otherwise it will be a PET.

These changes will alter the way advisers look at trusts where amounts in excess of the nil-rate band (currently £285,000) are in point. In general they make the use of trusts in divorce proceedings less tax effective than absolute transfers, except in special circumstances involving a disabled person.

Trusts will still be used in divorce settlements as, despite adverse tax consequences, they will in many circumstances be the only means to arrive at a solution acceptable to both parties. It is to be hoped that in a future Budget, amendments will be brought in to allow IIP trusts created on marriage breakdown to be subject to IHT under the pre-22 March 2006 rules.

13. CGT CHANGES AND TRUST MODERNISATION

As mentioned in Section 1, there has been lengthy consultation on the modernisation of the Income Tax and CGT treatment of trusts. Relevant provisions that have arisen out of this exercise have been brought in piecemeal, and some provisions have still to be finalised. HMRC have announced that the proposals with respect to income streaming, the abolition of the tax pool and changes to the way estates in administration are charged to CGT, are not being taken forward at this time because of difficulties in formulating the details.

a) Tax rate

Since 6 April 2004 all trusts have been subject to a 40% rate of CGT.

Despite the alignment of the IHT treatment of most IIP trusts with discretionary trusts, the Income Tax rules remain separate. From 6 April 2004 the rate applicable to trusts rose to 40% and the trust rate applicable to dividends rose to 32.5%. These two rates are collectively known as the special trust rates.

The rate applicable to trusts applies to all income received by a discretionary trust. From 6 April 2006 it also applies to any trust in receipt of the following income:

- deemed income receipts under the accrued income scheme
- profits on the disposal of deeply discounted securities where the trustees are resident in the UK
- offshore income gains
- payments made by a company on the redemption, repayment or purchase of its own shares or on the purchase of a right to acquire its own shares (in this case the dividend rate of 32.5% will apply)

- gains on contracts for life assurance
- gains on the disposal of land where the gain is brought within the charge to income tax by the anti-avoidance provisions
- profits of a property business in relation to lease premiums
- profits on the disposal of a future or option
- profits on the disposal of deposit rights
- proceeds of sale on a foreign dividend coupon
- chargeable events in relation to employee share ownership trusts.

b) Standard Rate Band

A £500 standard rate band for discretionary and A&M trusts was introduced in 2005/06 and for 2006/07 this has been increased to £1,000. The legislation provides that the special trust rates do not apply to this first £1,000 of gross income. Instead, tax is charged at 10%, 20% or 22%, depending on the nature of the trust income. There will be no further tax to pay if income is already received net.

The order in which this standard rate band is applied is:

(i) non-savings income; then

(ii) interest; then

(iii) dividends.

Where trust management expenses are also involved, these are set off in the reverse order. That is:

(i) dividends; then

(ii) interest; then

(iii) non-savings income.

Expenses must be grossed up at the relevant rate in each case.

Finance Act 2006 has introduced anti-avoidance provisions in cases where there are multiple settlements made by the same settlor. These provisions follow those applicable for the purposes of the CGT annual exemption. Where there are five or fewer settlements made by the same settlor, the standard rate band is divided amongst the settlements. Where there are more than five settlements each will have a standard rate band of £200.

It is important to remember that where a trust has a policy of distributing all its income, the payments to the beneficiaries have to be franked by a 40% tax credit. Unless there is a significant tax pool brought forward the trust will reap little benefit from the standard rate band as additional tax will have to be paid over to frank the payments to the beneficiaries. The additional tax resulting from distributions of dividend income (where the notional tax credit is lost) remains a problem.

c) Trusts for the vulnerable

Finance Act 2005 brought in a special Income Tax and CGT regime for trusts for vulnerable beneficiaries. The start of the regime was backdated to 6 April 2004.

To qualify for the regime the beneficiary must be either a relevant minor or a disabled person.

A relevant minor must be under 18 and have lost at least one of his parents. Furthermore, the trust must have been established either in the will of a deceased parent, under the Criminal Injuries Compensation Scheme or on intestacy (in this case the relationship with the beneficiary is not prescribed). Where the trust is set up in the deceased parent's will or under the Criminal Injuries Compensation Scheme:

(i) on attaining the age of 18 the relevant minor must become absolutely entitled to the trust property, any income arising from it and any accumulated income, and

(ii) until the vulnerable beneficiary reaches 18, for so long as he is living, any property applied must be applied for his benefit, and

(iii) until the vulnerable beneficiary reaches 18, for so long as he is living, either he is entitled to all the income (if there is any) arising from the trust property, or no such income may be applied for the benefit of any other person.

A disabled person is defined in broadly the same terms as the revised definition of a disabled person for IHT (section 3b above). If the beneficiary qualifies as a disabled person then, as with relevant minors, the following additional conditions must be satisfied during the lifetime of the disabled person or until the termination of the trust (if this occurs before his death):

(i) if any of the property is applied for the benefit of a beneficiary, it is applied for the benefit of the disabled person; and

(ii) either the disabled person is entitled to all the income (if there is any) arising from the trust property or no such income may be applied for the benefit of any other person.

The legislation specifies that the statutory powers of advancement will not cause a trust for a relevant minor or a disabled person to fail the specified conditions.

If both the trust and the beneficiary meet the conditions then an election may be made to opt into the regime. This election applies for both Income Tax and CGT, is irrevocable, must specify an effective date, and must be made jointly by the trustees and the vulnerable beneficiary. The deadline for making the election is 12 months after 31 January following the tax year in which the effective date falls. 2004/05 was the first year that the new rules can be applied and the deadline for an election to be made for that year is 31 January 2007. There are special rules where the election is only to be effective for part of a tax year.

Different rules apply for Income Tax and CGT purposes.

For Income Tax the trustees need to carry out two calculations. Firstly, they calculate the tax they would pay under normal rules and then they calculate the lower amount of tax the vulnerable beneficiary would pay if the income were his personally. The trustees can claim a deduction equal to the difference between these two amounts from their Income Tax liability.

It should be noted that the vulnerable beneficiary regime does not change the fact that any distributions have to be franked with a 40% tax credit. Unless the trust has a significant brought forward tax pool, additional tax will have to be paid before the distribution can be made and the trust will be in the same position as it would have been under the normal rules.

For CGT purposes chargeable gains arising within the trust are treated as if they arose to the vulnerable beneficiary in a personal capacity and not to the trustees. As such, where the vulnerable beneficiary pays tax at less than the higher rate, there are clear benefits from making the appropriate election.

d) Common definitions of settlor and settled property

From 6 April 2006 the rules for Income Tax and CGT have been aligned so that there is a common definition of 'settled property' and following this a common meaning of a settlement.

Settled property means any property held in a trust other than property:

- held by a person as nominee for another
- held by a person as trustee for another person(s) who is absolutely entitled as against the trustee
- held by a person as trustee for another person(s) who would be absolutely entitled as against the trustee if he were not an infant or otherwise under a disability.

A common definition of 'settlor' has also been introduced. A person is a settlor by reason of his having made the settlement or if the property within a settlement derives from property which he settled. The settlement can be entered into and the property provided either directly or indirectly. A person who has entered into reciprocal arrangements connected with the creation of the settlement will also be a settlor. This is without prejudice to existing anti-avoidance provisions for Income Tax.

e) Transfers between trusts

Where property is transferred from one settlement to another (other than for full consideration or by way of a bargain at arm's length) the settlor(s) of the original settlement will be treated from the time of the disposal as the settlor(s) of the second trust. Property provided for the purposes of the first settlement or derived from such property that is transferred to the second settlement will be treated from the time of the disposal as having been provided for the purposes of the second settlement.

f) Identification of the settlor where a will or intestacy is varied

Where property would, but for a variation, have been comprised in a settlement:

(i) arising on a person's death in accordance with either his will or intestacy, or

(ii) already in existence on the person's death (whether or not the deceased person was a settlor in relation to that settlement),

the deceased person will be treated as the settlor where the effect of the variation is to redirect assets such that they become comprised in another settlement, subject again to the broader definitions in the anti-avoidance code. Thus, for example, a disclaimer by a life tenant in favour of minor children will mean that the life tenant is also treated as settlor during his or her lifetime.

In all other situations it will be the person who immediately before the variation was entitled to the assets who will be the settlor. Thus, a legatee who would have been entitled to property but for the variation will be treated as the settlor of the trust arising as a result of the variation, even if an infant or under a disability.

g) Variations

Variations of property established in a will trust are possible even if the beneficiary only has a life interest. According to HMRC it is not possible to vary a life interest after the death of the life tenant: this point has yet to come before the English courts. HMRC accept that a life tenant can vary before death. A life tenant's personal representatives can disclaim the benefit of a life interest if the deceased dies before accepting it.

An appointment out of a discretionary trust made within two years of death (and therefore read back) can be combined with a variation by the relevant beneficiary (also read back if made within two years).

h) Sub-funds

Subject to conditions, the trustees of a settlement will be able to elect to treat a sub-fund as a separate settlement. The election applies for Income Tax and CGT purposes.

The election is irrevocable and must:

(i) be made by notice to an officer of HMRC in such form as HMRC may require, and

(ii) specify the date on which it is to be treated as taking effect (this date cannot be later than the date on which the election is made).

A sub-fund election cannot take effect before 6 April 2006. To be effective the election must be made by the second 31 January after the year of assessment from which the election is to be effective. Each of the trustees of the

principal settlement must make a declaration that he agrees to the election.

Trustees may make a sub-fund election only if:

(i) the principal settlement is not itself a sub-fund, and

(ii) the sub-fund is not the whole of the property comprised in the principal settlement (that is some property is left in the principal settlement), and

(iii) the sub-fund does not contain any property over which the principal settlement has an interest, (i.e. assets cannot be owned jointly), and

(iv) the sub-fund and the principal fund must have different beneficiaries. A single common beneficiary would be sufficient to breach this condition.

Where there are different trustees for different parts of the fund or the trustees hold funds for disparate beneficiaries, this could be a useful provision. However, the election will trigger a CGT disposal on the assets within the sub-fund. As such the trustees will have to weigh the benefits of simplified administration and compliance against the initial CGT cost.

i) Settlor-interested trusts

The income of discretionary trusts in which the settlor retained an interest has previously been taxed on the settlor himself and exempted from charge at the special trust rates of Income Tax in the trustees' hands. This treatment ends as from 6 April 2006 and such income will now be subject to tax on the trustees, and therefore at the special trust rates (40%/32.5%). Unfortunately, the legislation gives no credit or exemption to the settlor (whose income it is still deemed to be) but HMRC have confirmed in correspondence that they will not seek further tax from the settlor (who will be deemed to have a corresponding credit). It remains to be seen how reporting requirements will be dealt with when Self-Assessment Returns are published.

Finance Act 2006 legislates for the current practice of not taxing other beneficiaries who receive discretionary income payments from the trustees of a settlor-interest trust. Such beneficiaries are treated as having received the income franked with a 40% tax credit. The tax credit is never repayable.

The rules to determine whether a UK resident settlement is settlor-interested for CGT purposes have been extended to include those trusts where a dependent minor child of the settlor, who has not entered into either a marriage or civil partnership contract, can benefit. Therefore, CGT holdover relief will not be available where assets are transferred to a trust in which a minor child of the settlor can benefit even where there is now an immediate charge to IHT.

j) Trust management expenses - HMRC guidance

HMRC issued a paper entitled "Trust Management Expenses Guidance" in January 2006. The paper sets down HMRC's view on allowable expenses and the timing of the deduction. In their view, most expenses will not be allowable against income and expenses are not deductible until they have been paid, even if they properly relate to a previous tax year.

It was hoped that HMRC and the professional bodies would be able to reach a consensus on this issue but, while a measure of agreement has been achieved, significant points of dispute remain. One subject of contention is the deductibility of trustees' fees. HMRC deny any deduction whatsoever for such fees against income, on the grounds that they are for the benefit of the settlement as a whole and so are a charge to capital; conversely, others contended that fees and remuneration properly chargeable to income should be deductible. There is to be a test case on this and other aspects of the allowable expenses to be heard before the Special Commissioners in December 2006.

14. TRUSTEE RESIDENCE AND ANTI-AVOIDANCE

a) Trustee residency

The current rules

Currently there are separate tests for the residence of trusts under the Income Tax and CGT rules.

For Income Tax purposes a trust is UK resident if either:

(i) all the trustees are UK resident, or

(ii) at least one trustee is UK resident and the settlor was UK resident, ordinarily resident or domiciled at the relevant time.

The relevant time in the case of a will trust is the settlor's death. For a lifetime trust it will be the time when the settlor is treated as making a settlement, or adding to it.

Currently, for CGT purposes a trust is UK resident unless:

(i) the general administration of the trust is carried on outside the UK, and

(ii) a majority of the trustees is, in the year concerned, not UK resident or ordinarily resident.

A specific provision allows UK professionals (whether they are UK resident, ordinarily resident or domiciled or just carry out their duties in the UK) to act as trustees without prejudicing a trust's non-residence status. The rule only applies where the settlor of the trust was not domiciled, resident or ordinarily resident in the UK at the time of the settlement. Professionals who are acting as trustees in the course of their professional business, are deemed, under these conditions, to be non-resident and the administration they undertake is deemed to be carried out outside of the UK.

The new rules

The trustees of a settlement are to be treated as a single person for the purposes of the Taxes Act, except where the context otherwise requires. To determine the residence status of the trust, the trustees are considered individually.

From 6 April 2007, the residence of trusts for Income Tax and CGT will be determined according to the current Income Tax rules, described above. It will no longer be possible for a trust to be UK resident for Income Tax purposes but not for CGT. It was originally proposed that there should be a provision to maintain the deemed non-residence of UK professional trustees, but this has been dropped as it was thought to constitute State Aid and consequently breach EU provisions.

Depending on circumstances, UK professional trustees may have to consider the appointment of foreign co-trustees, or resign before 5 April 2007, so as not to bring the trust within the charge to UK CGT.

Great care will have to be taken not to change the residence status of the trust inadvertently where an existing trustee changes his residence status by either coming to or leaving the UK.

If a trust was established by a settlor resident, ordinarily resident and domiciled outside the UK, but which is nevertheless UK resident (because all the trustees are UK resident), a charge to CGT could be triggered by accident if one of the trustees leaves the UK permanently. This would mean that there was then a mixture of resident and non-resident trustees, and since the settlor was not connected to the UK when the settlement was made, the trust would become non-resident, with a consequential charge to CGT on a deemed disposal of assets within the trust. It is, therefore, important that trustees are made aware of the implications of their personal residence status, so that they take advice and avoid the adverse consequences of an unanticipated charge. The pre-existing relief for settlements temporarily exported as a result of the death of a trustee (but where UK residence is re-established within 6 months) remains.

b) Anti-avoidance

The trust modernisation proposals have meant that there is no Income Tax or CGT saving where assets are held within discretionary trusts rather than by individuals absolutely.

A settlor cannot achieve a tax saving by settling assets into trust for himself, his spouse or a minor child. In any of these cases the income and gains will be taxed on the settlor on an arising basis.

Complex anti-avoidance provisions (dealing with the transfer of assets abroad) negate any tax saving that might arise to a UK resident, ordinarily resident and domiciled individual from the use of an offshore trust structure.

The Finance Act implements changes with effect from 5 December 2005 (when they were published) altering the tests for the defence against the application of the anti-avoidance code relating to the transfer of assets abroad. The intention is to make the "motive defence" more objective, so as to avoid judging the actual intentions of the taxpayer, but rather assessing what it would be reasonable to conclude his intentions to have been. The intentions of professional advisers can be taken into account in determining this. It will now be more difficult for an offshore settlement made by a UK resident, ordinarily resident and domiciled individual to avoid being caught by the anti-avoidance provisions.

Following the decision in Davies v Hicks against HMRC, the Finance Act 2006 amends the matching rules with respect to share sales. From 22 March 2006 the 30 day rule will not apply where the purchaser is not UK resident (by general law or by treaty) at the date of the re-purchase. In that case the sale will be matched to earlier purchases.

In Davies v Hicks, a trust had become non UK resident, and the trustees successfully avoided CGT on emigration by a sale of the securities they held before becoming non resident, and re-acquiring them within 30 days but when they were resident abroad. The sale and re-acquisition were matched as the shares were re-acquired within 30 days, and as a result there was no UK CGT on the sale. Equally as the settlement only contained cash (and no chargeable assets) when it was exported, there could be no CGT charge on that occasion. Purchases and sales will no longer be matched in such circumstances with effect from 22 March 2006.

15. CONTINUING TAX PLANNING OPPORTUNITIES

While we may regret the changes to IHT as it applies to trusts, these will not result in an end to the widespread use of settlements for financial, family or indeed tax planning. In many circumstances even with an immediate charge at the lifetime rates, a decennial charge at 6% will prove a reasonable alternative to a death charge at full rates every generation. It will certainly be preferable to gifts which jeopardise assets or pass funds to beneficiaries incapable of (or uninterested in) managing wealth.

Of course there will be concern that the rate of the decennial charge may prove an easy future target for increase, and planning will have to take account of this risk. Going forward it may be important for both spouses/civil partners to utilise their nil-rate band every seven years. If one spouse/civil partner has more assets than another, estate equalisation may be a part of this process. Provided the gifts are absolute, should the donee spouse choose to make a gift into a trust, this will not be caught by any IHT anti-avoidance provisions.

Where individuals have a substantial annual income they may be able to make regular or substantial annual gifts out of surplus income, within the exemption for normal income expenditure.

Business and Agricultural Property Relief can also be used to good effect both in trust planning and general IHT planning, subject to being held for the requisite period. Investment vehicles (likely to be appropriate only where large sums require shelter) are being developed which seem to take advantage of these reliefs, after the investment has been held for the requisite period, with risks managed by the structure or the promoter. Such products will have to be assessed carefully for their merits as investments.

Value freezing structures may be considered, whose purpose is broadly to create a new classes of shares with low values initially, but which accrue worth as time passes.

Where there is sufficient wealth, grandparents could also create a nil-rate band trust for their grandchildren. The initial gift would be covered by the nil-rate band and so advances made in the first ten years for the grandchildren's maintenance, education and benefit would be tax free. In this way it would be possible to remove a significant amount of the value in the fund such that any principal charge due should be relatively low.

16. ALTERNATIVES TO TRUSTS

The Government have given no indication that the changes to the way IIP and A&M trusts are taxed for IHT purposes is the first part of a wider strategy to make all lifetime gifts chargeable. As such, absolute gifts to individuals can still be made without triggering an immediate charge to IHT. Provided the donor survives for seven years there will be no IHT to pay except on the death of the donee.

An absolute gift can be made to a minor as it can be held on a bare trust. For tax purposes the infant is treated as absolutely entitled to the assets and so the gift is a PET and not subject to the exit or principal charges. A bare trust for a minor is effective for CGT purposes as gains realised may utilise the child's annual exemption.

While a minor would have to wait until aged 18 before unrestricted access to capital, and below that age be entitled only to provision for maintenance, education or benefit, in other cases absolute gifts mean that the recipient will be able to do as he likes with the property gifted. This may be exactly the situation the donor wants to avoid as he fears the beneficiary might not have the maturity to manage such a gift. In this situation one can look to investments whose nature means that the underlying capital is locked away for a fixed term of years (by when it is hoped the donee will have the maturity to handle such a sum) and in the short term the donee will only receive income. New products are coming to market along these lines, though again these may require a high minimum level of investment. One example works by locking the capital away for ten years. There is no surrender value so the donee cannot realise cash and a return of 2% per annum is paid. On redemption 125% of the initial investment will be paid back. This does of course lack the flexibility of a trust as with a trust the trustees can be given the discretion to advance capital to beneficiaries should the need arise.

Certain insurance products can also carve out separate interests in income and capital. A donor might be happy to purchase such a product and gift the income element whilst retaining the capital element and possibly gifting this to the donee when he judges the donee is mature enough. The insurance industry is currently working on a new range of products that will take account of the Finance Act changes, and these are expected to be available by September 2006.

It is anticipated that in the future most life assurance policies will either be held on bare trust or directly assigned to the beneficiaries.

Joint ownership of assets might also achieve the desired result of decreasing the donor's estate while still enabling the donor to prevent a sale of the underlying asset.

It might also be possible to achieve a result similar to an IIP trust, where one class of individuals has the right to income and on the termination of this interest another class has the right to capital, through using a partnership structure with a very specific partnership agreement. The limited liability protection made available by the Limited Liability Partnership structure introduced in 2000 might be utilised in forming an investment partnership. The opportunities for estate and succession planning that such a structure might offer were relatively unexplored before the Budget. Following the IHT changes to the taxation of trusts, these structures will be evaluated to determine whether they can be constructed so as to be fit estate planning objectives.

An individual who wishes to make a gift but wants to ensure that the beneficiary cannot benefit until an age when he is mature enough to handle the assets could establish or make a gift into an existing pension fund for the beneficiary. If the individual has significant surplus income he might be able to set up regular payments in such a way as to fund the policy by gifts exempt from IHT as made out of surplus income. A gift into a pension fund might of course be deferring the benefit to the beneficiary somewhat longer than is intended!

17. CONCLUSION

The Budget changes constitute a fundamental change to a regime which had existed since the introduction of Capital Transfer Tax in 1974, and which had much to recommend it in terms of equity and basic sense. It is hard to understand what significant abuses HMRC perceived or what concerns prompted so radical a reform, which seems not so much intended to raise revenue as to discourage prudent estate planning and the conservation of wealth.

It is equally regrettable that these changes, fundamental as they are, were introduced without consultation with the result that the draft proposals required significant amendment (as allowed by the Government), revealed basic misunderstanding of the nature of trusts and their role in estate planning, and practically negated much of the work

put in by other sections of HMRC, which had been engaged in constructive and extensive consultation on other aspects of the modernisation of the tax treatment of trusts.

The changes will undoubtedly have a significant effect on the use of trusts, and will necessitate significant professional advice (and costs) in relation to existing settlements and re-consideration of wills.

However, trusts have long been important vehicles for estate planning in the UK, and their flexibility to changing situations, family circumstances, and the needs of beneficiaries will ensure that they continue to play a useful role. While new trusts will, in many cases, fall within the relevant property regime, and gifts into settlements will be chargeable rather than potentially exempt, this may not inevitably prove a greater cost when IHT reliefs and CGT hold-over are taken into account, and when the combined cost of the initial and decennial charges are compared with the generational charge at the full rates of tax that has been found acceptable for IIP settlements. It may be acknowledged that much will depend upon the confidence which settlors and advisers place in that decennial rate being maintained, and it is to be hoped that the Government will recognise the need to encourage confidence in the stability of the new regime.

The process of fiscal legislation has not been helped by these changes. They have been introduced ill-advisedly and without proper discussion. As a result amendments have been made which to avoid the appearance of a climb-down - or the complexities of a re-write - have resulted in layers of supplementary codes, greatly increasing (to the point of opacity) the complexity of legislation.

Nevertheless, the initial proposals have been modified during the progress of the Bill and while the end result is not to be welcomed, it is significantly better than it might otherwise have been, and may in time serve to encourage the proper use of more flexible settlements than we, in the UK, have been accustomed to. There is a need for clients to reconsider their wills - if prepared in anything other than the simplified form - with their advisers, and for trustees of A&M settlements to consider their position during the transitional period. New planning mechanisms and vehicles may come to the market, but it is unlikely that the trust will be displaced from its role in family estate planning.

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