

HOW ROSY IS THE FUTURE FOR EXISTING TRUSTS?

or

What can be done with existing trusts in the light of the Finance (No.2) Bill 2006?

The sweeping changes to the inheritance tax treatment of trusts introduced by the Finance (No.2) Bill 2006 (“the Finance Bill”) have been the subject of considerable criticism, not least from the House of Lords select committee that found it difficult to identify the underlying purpose or target of the changes. However, as a starting point to the understanding of the changes, it may help to note the Treasury’s misguided notion that the “standard” tax treatment is and always has been what many of us have always thought of as the discretionary trust régime, with its denial of treatment as a potentially exempt transfer (“PET”) on any lifetime gift into the trust, and with ten-yearly and exit charges. On that misguided Treasury view, interests in possession fell within a privileged class. The rest of us might have been forgiven for thinking that the standard treatment was that given to interests in possession, which involved the life tenant as being treated as though he or she was beneficially entitled to the underlying property in which the interest subsisted. Undoubtedly accumulation and maintenance trusts (“A&M trusts”) did occupy a privileged position, but in general they could be seen as a sensible way of providing for the situation before a child became entitled to an interest in possession at some time at or before age 25.

The Finance Bill introduces two major shifts in the approach to which we had become accustomed.

First, it will no longer be the case that all interests in possession count as “qualifying” so as to fall outside the discretionary régime. By and large it is only the first life interest created by a Will or on an intestacy that will be “qualifying”, so there will be many cases in which the discretionary régime applies even though there appears to be a life interest rather than a discretionary trust. That will be the case with new lifetime gifts into trust and also with second life interests under will trusts coming into effect on or after 22.3.06 (i.e. Budget Day, “BD” for short).

Secondly, the privileged treatment for A&M trusts will be replaced with a more restricted privilege for bereaved minors’ interests – i.e. broadly only those which are created by the Will or intestacy of a parent (or person in loco parentis) for a child under the age of 18 who will become absolutely entitled at age 18 (or age 25 at some tax cost).

Trusts existing immediately before BD, whether created inter vivos or by the Will or on the intestacy of a person dying before then will not be wholly immune from these changes. There are, however, important transitional reliefs. The purpose of my talk is to look at how existing trusts will be affected and at what can be done with them. The main focus will be on interests in possession and on A&M trusts.

Interests in Possession

Where a person had an interest in possession immediately before BD, the “old” rules will continue to apply to that interest for the rest of its duration. Incidentally, if further property is added on or after BD to an interest in possession settlement, it will probably be the “new” rules that apply to determine the treatment of that added property, but without tainting the property already in settlement.

We are going to have to cope with some new jargon, because the “old rules” will also apply to a “transitional serial interest” (“TSI”) for its duration. A TSI is an interest in possession to which a person becomes entitled on or after BD but before 6.4.08 if that entitlement arises on the termination of a prior life interest that was itself in existence immediately before BD. I will deal separately later with the special position of TSIs for surviving spouses.

In very broad terms this means that the trustees can heave a short-term sigh of relief if there was a beneficiary who had a life interest immediately before BD, but it will still be necessary to see what is due to happen when that life interests ends.

Existing life interest followed by absolute entitlement: If somebody (the existing life tenant or anybody else) will become absolutely entitled on the ending of the life interest, the position will be no different from that under the “old” rules.

Existing life interest followed by another life interest: If another life interest is going to follow the existing one, then the trustees (and the existing life tenant) will need to consider whether it is desirable to terminate the existing interest before 6.4.08 so as to bring that second life interest into possession, so that it can be a TSI. That could well be the case if the trusts are to A for life, subject thereto for his son B for life, remainder to B's children: wait until 6.4.08, and if A dies on or after that date, what B gets will not be a "qualifying" interest in possession so the discretionary régime (the Treasury's standard treatment) will apply. Bear in mind also that if that does happen you will not necessarily have 10 years before the first ten-yearly charge hits – the 10-year anniversaries are calculated from the commencement of the settlement, not from when the discretionary régime first applied.

Existing life interest followed by A&M trusts: What happens if the life interest will be followed by A&M trusts? Whether by oversight or by design, this sort of situation is less favourably treated than that in which the A&M trusts were actually operational immediately before BD. Three things hamper the trustees' ability to adapt to the changes:-

- (i) Although para 2 of Schedule 20 to the Finance Bill is headed "Section 71 of IHTA 1984 not to apply to property settled on or after 22nd March 2006", it goes wider than that and provides that section 71 (the A&M section) will not apply to settled property on or after BD unless it applied to the property immediately before BD. In the scenario that we are considering, s. 71 will not have

applied at BD because of the previous life interest. So the A&M trusts when they come into operation will never be within s. 71 as amended.

- (ii) In many cases it will not be possible to adapt to fit the new s. 71A as trusts for bereaved minors (nor the new section 71D 18-25 trusts) for the simple reason that the trusts will not have been established under the Will or intestacy of the child's parent.
- (iii) As discussed under option (b) in the section on A&M trusts below, there are some circumstances in which one can convert to an 18-25 trust even though the settlor was not the child's parent and the settlement was not made on death. However, that possibility depends on the operation of the new section 71D(3), which in effect requires that the property should cease being held on old-style s.71 A&M trusts on or after BD. As just mentioned in (i), that will never happen in the scenario that we are considering at the moment because the prior life interest in existence at BD means that s.71 will never apply: if it never applies, it cannot cease to apply.

So, just about the only options are as follows:-

- (a) Where one parent by Will established trusts for the surviving spouse for life with remainder on A&M trusts for the children of the marriage, consider without any delay whether there may be scope for adapting to the new régime with a bereaved minor's trust or an 18-25 trust to follow the existing life interest.

- (b) If that is not available (for instance, in the case of a grandparent's settlement on son for life with remainder on A&M trusts for grandchildren), consider again without delay making sure that the child will take absolutely on the termination of the previous life interest.
- (c) Consider terminating the previous life interest before 6.4.08 in favour of giving the child (even if a minor) an immediate life interest that will qualify as a TSI.
- (d) Leave the trusts as they are, accepting that the discretionary régime will apply with its ten-yearly and exit charges.

Late amendments introduced at the Report Stage are supposed to have eased the position where trusts provide a life interest for one spouse and then a successive life interest for the surviving spouse (whether under the original trusts or under a power of appointment). The idea seems to have been to ensure that the surviving spouse's life interest will be a TSI even if it only falls into possession on or after 6.4.08. The amendments (embodied in a new section 49BB IHTA 1984) work well enough where the first spouse's life interest was in existence immediately before BD, but will not apply where the first life interest was not in possession at that time (either because the settlement did not even exist or because of some prior interest).

A&M Trusts

Assuming that the trusts were operational at BD so that s.71 applied at that stage, and assuming it has continued to do so since then, these trusts will at least still fall within s. 71 until 5.4.08. However, with effect from 6.4.08 s.71 will

be amended so that to meet the requirements of the section the trusts will have to provide for the child or children to take absolutely at age 18.

One point to note is that existing A&M trusts typically provide for the child to gain a life interest at an age somewhere between 18 and 25. One might have expected that life interest to qualify as a TSI provided at least that it happened before 6.4.08, but that expectation has been sadly disappointed. Such a life interest will not be a TSI because it will not have succeeded an interest in possession in existence immediately before BD, so the discretionary régime will apply even though the child has a perfectly good life interest.

The trustees of an existing A&M trust therefore seem to have the following restricted options:-

- (a) If the settlement was created by the Will or intestacy of the parent of (or person in loco parentis to) the beneficiaries, then it may be possible to exercise trust powers so that the beneficiaries will become absolutely entitled at age 18, so that the trusts will meet the requirements for a bereaved minor's trust (the new s. 71A). If that is going to be done, then it should be done before 6.4.08.
- (b) As an alternative to (a), one might consider exercising the trust powers so as to bring the trusts within the new s. 71D with its age 18-to-25 trusts. That means that the beneficiaries will have to become absolutely entitled at age 25 at the latest. Delaying absolute entitlement beyond age 18 comes at the price of a tax charge in respect of the period of postponement (but the effective rate cannot exceed 4.2% and

may in practice be somewhat lower than that). Unlike the situation under (a) (where conversion into a bereaved minor's trust is only available where the settlement was created by the Will or intestacy of the parent), conversion into an 18-to-25 trust is possible for existing A&M trusts regardless of who was the settlor and regardless of whether the settlement arose by lifetime gift or on death. Again, conversion should be achieved before 6.4.08.

- (c) There is also the option of exercising the settlement powers so as to continue to fall within s. 71 even after 6.4.08, which will mean exercising the powers before then so as to ensure that beneficiaries will take absolutely at 18. It is not entirely clear why anyone would want to go down this route: in most cases the same effect could be achieved by converting to an 18-to-25 trust and thus preserving the flexibility to decide at some future point whether to vest capital absolutely at age 18 or to defer vesting till 25 with the tax cost mentioned above.
- (d) None of the above options may be available if the trusts have insufficient flexibility and powers (although if trustees' get their skates on there should be time before 6.4.08 to apply under the Variation of Trusts Act 1958 with a view to writing in the necessary powers). In many cases there may also be perfectly good family reasons for not going down any of the above routes. If the trusts are left to run their course, it will have to be accepted that the discretionary régime will apply from 6.4.08 onwards (even after children have acquired life interests) until absolute entitlement occurs. That will mean incurring the 10-yearly charges (at a maximum rate of 6% every ten years) –

remembering that the 10 year anniversaries are calculated from the commencement of the settlement not from the date of falling into the discretionary régime – and an eventual exit charge (again at a maximum rate of 6%). Depending upon the circumstances, the trustees may be able to mitigate or remove the tax charges by investing in assets that attract BPR or APR. It should not, however, be overlooked that there may be adverse capital gains tax consequences of remaining in the discretionary régime: for instance, if the pattern of the trust gives the child only a life interest with remainder to his or her children, the CGT-free uplift in value that would previously have been available when absolute entitlement occurred on the death of the life tenant will no longer be obtained. Perhaps the only good news is that if one follows the route of leaving the trusts to run their course, there will be no immediate charge to IHT when the trusts automatically cease to satisfy section 71 on 6.4.08: but for a generous provision to this effect in the Bill, there would have been – be grateful for tiny mercies.

The general message for all existing trusts has to be to review the situation in good time before the transitional period expires on 5.4.08. Unfortunately, one has to assume that there is unlikely to be a change of Government or of the law before then. If you miss the end of the transitional period, you will be left hoping for a change of Government or of the law before an event happens under the trust that will cause a tax charge under the new system. That will obviously involve taking a risk: whether that risk is acceptable will depend upon the individual circumstances of each particular trust and its beneficiaries.

Finally, the Finance Bill is due to receive Royal Assent on the 19th or 20th of July, so with a mixture of relief and resignation we can probably assume that the die is cast, at least until the next Pre-Budget Statement in November or December.

Andrew Cosedge
3 Stone Buildings
Lincoln's Inn

11th July, 2006