

## WHAT TO DO WITH TRUSTS CREATED BEFORE 22ND MARCH 2006?

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The changes introduced by Finance Act 2006 have been with us for some time now. Although there was initially a good deal of shock and opprobrium at both the nature of the changes and the manner of their introduction, the issue now facing practitioners, as much as what to do about creating new trusts, is what to do with those created before the changes took effect on 22nd March 2006. This issue obtains increasing urgency as we approach the 5th April 2008 deadline after which such transitional provisions as there are will cease to apply.

This lecture seeks to address some of the more common issues which arise in practice. Some of these issues arise simply because of the nature in which the changes are intended to work. Unfortunately, however, a good deal of problems can be seen to arise as a result of drafting which leaves a lot to be desired. Further, while a purposive approach to construing the changes offers some clarity, it cannot be assumed that the Court will adopt such an approach in the face of HMRC opposition (see for example the decision of the Court of Appeal in *Frankland v IRC* [1997] STC 1450).

As an initial point it would seem prudent to review the situation of all trusts which were in existence prior to 22nd March 2006 before 5th April 2008, the date when transitional provisions will cease to have effect. It is not, however, only those trusts which can benefit from the transitional provisions which are likely to be affected.

### **General considerations**

Obviously, the changes to the inheritance tax treatment of trusts introduced by Finance Act 2006 cannot be considered in a vacuum. A number of additional considerations will be relevant in determining the most suitable course of action to take, if any.

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Inheritance tax is unlikely to be the only tax to be of relevance to the trust. An absolute appointment of trust assets might result in avoiding a 6% inheritance tax charge every ten years, but if it results in significant trust gains being subject to a 64% capital gains tax charge it is hardly likely to be worth it.

Furthermore there are likely to be a number of non-tax considerations which must be taken into account. Trusts are a useful tool for protecting and preserving wealth. They can also ensure assets are available to benefit a wide range of persons according to their respective needs. Such considerations may very well dampen the tax concerns.

Related to this is the likely lifetime of the trust. The amount and timing of any inheritance tax charge should be considered as against the intended duration of the trust. It should also be considered as against the likelihood of a further change in the law at some point in the future.

Finally, it is to be noted that different considerations may apply to different funds. A review of the situation may lead to the conclusion that it is preferable to wind up some funds as the cost of leaving them outstanding outweighs the administrative convenience of retaining the status quo. It may also save on future tax charges.

### **Trust law considerations**

While it may be possible to mitigate the effects of the changes to the inheritance tax treatment of trusts introduced by Finance Act 2006 as a matter of tax law, a necessary precursor to any consideration of such points will be a consideration of what changes can be achieved as a matter of trust law.

In particular, it is irrelevant if somewhat different trusts might result in a tax saving if it is impossible, regard being had to the terms of the trust in question, to alter the terms of such trust.

This will be a particular concern with respect to accumulation and maintenance trusts (especially the older ones), the terms of which will have involved restricting the dispositive powers available to the trustees. The manner in which this is done may differ significantly from trust to trust. As such, it will be necessary to have regard to the terms of the actual trust.

Having regard this point, it follows that the following comments and considerations can be of general application only, and must be considered in the context of each particular settlement.

## The new inheritance tax regime for trusts

One effect of the Finance Act 2006 changes is that there are now two parallel regimes governing the taxation of interest in possession settlements. This has the consequence that it is no longer possible to determine the inheritance tax treatment of a settlement simply by having regard to the terms of the trust. Separate trusts on identical terms, and indeed different parts of the fund of a single trust may be subject to different inheritance tax treatment.

It is obviously important to be in a position to determine which regime applies, and also to have regard to how the inheritance tax treatment of any given trust might be prejudiced.

The default position is that property held in settlement will be relevant property within section 58 IHTA 1984 unless some provisions applies to prevent that treatment applying:

- (1) *In this Chapter “relevant property” means settled property in which no qualifying interest in possession subsists, other than-*
  - (a) *property held for charitable purposes only, whether for a limited time or otherwise;*
  - (b) *property to which section 71, 71A, 71D, 73, 74 or 86 below applies (but see subsection (1A) below);*
  - (c) *property held on trusts which comply with the requirements mentioned in paragraph 3(1) of Schedule 4 to this Act, and in respect of which a direction given under paragraph 1 of that Schedule has effect;*
  - (d) *property which is held for the purposes of a registered pension scheme or section 615(3) scheme;*
  - (e) *property comprised in a trade or professional compensation fund; and*
  - (f) *excluded property.*

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The categories of trust which will not be subject to the relevant property regime can be seen to be as follows:

1. Qualifying interest in possession trusts;

2. Charitable trusts;
3. Accumulation and maintenance trusts falling within section 71 IHTA 1984 as amended;
4. Trusts for bereaved minors (section 71A IHTA 1984);
5. Age 18 to 25 trusts (section 71D IHTA 1984);
6. Pre 12 April 1978 protective trusts (section 73 IHTA 1984);
7. Pre 10 March 1981 disable persons trusts (section 74 IHTA 1984);
8. Employee trusts (section 86 IHTA 1984) satisfying the criteria in section 58(1A) to (1C) IHTA 1984;
9. Qualifying maintenance funds for historic buildings (Schedule 4 IHTA 1984);
10. Qualifying pension schemes;
11. Trade or professional compensation funds; and
12. Excluded property trusts.

As regards trusts existing on 22 March 2006, the most relevant categories are qualifying interests in possession and accumulation and maintenance trusts, for these are the two most significant classes of trusts which have been affected by Finance Act 2006.

### **Relevant property trusts**

The consequence of settled property being subject to the relevant property regime will broadly be that there will be (section 64 and 65 IHTA 1984):

- a charge on the ten year anniversary of the commencement of the settlement (a ten year charge) and
- a charge when property comprised in the settlement ceases to be relevant property and/or when the trustees of the settlement make a disposition as a result of which the value of relevant property is less than it would be but for the disposition (an exit charge).

It is noted that one of the most significant changes introduced by FA 2006 is that the ability to make potentially exempt transfers by transfer to a trust has been severely restricted, although it is still possible to make a potentially exempt transfer by way of gift to an individual (see section 3A(1A) IHTA 1984).

Prior to the introduction of the changes to the inheritance tax treatment of trusts in FA 2006, one of the principal attractions of interest in possession accumulation and maintenance trusts was the ability to settle property on them by way of potentially exempt transfer (section 3A(1)(c) IHTA 1984). Indeed, it may very well have been the case that a discretionary trust within the relevant property regime would have been preferable, but for the fact that it required a chargeable transfer of value (see for example *Drafting Trusts and Will Trusts* James Kessler QC (7th ed. 2004) at 14.2 (Using A&M Forms Unnecessarily)).

This is not a significant problem for pre-22 March 2006 settlements. Where it is relevant, however, is in assessing the drawbacks of the extension of the relevant property regime. If the main reason for adopting a trust of a given type was to obtain the benefit of a potentially exempt transfer, then the extension of the relevant property regime may not be so much of an issue. This will, however, depend upon the charge to be applied on ten year anniversaries.

### **Calculating the ten year charge**

It is trite to say that a maximum rate of 6% will apply. In practice, however, a much smaller rate may apply. Obviously it is necessary to determine the rate of the ten year charge before its consequences can be fully appreciated. Unfortunately, however, the provisions are relatively complicated and difficult to explain. Nevertheless, a basic approach to the ten year charge is set out below.

The first point to note is that although there is a single settlement from a trust law perspective, there may be a number of settlements for inheritance tax purposes. Generally, the greater the number of settlements, the lower the value of the trust property in each and accordingly the lower the ten year charge.

Issues of relevance in this respect are whether the settlor or his spouse had an initial interest in possession in any part of the settlement. If so, that part will be treated as a separate settlement (section 80 IHTA 1984). Further, if property derived from a different settlement it will be treated as if it remained comprised in that settlement (section 81 IHTA 1984).

Perhaps the most common situation is where there is more than one settlor (for example spouses contributing assets jointly). Section 44(2) IHTA 1984 provides that where there is more than one settlor and the circumstances require (which they do in calculating the ten year charge) then Part III IHTA 1984 (which contains the ten

year charge provisions) is to apply as if there are separate settlements.

The rate of charge on a ten year anniversary is determined in relation to each inheritance tax settlement in accordance with sections 66 and 67 IHTA 1984. Subsections (1) and (2) of section 66 IHTA 1984 provide as follows:

- (1) *Subject to subsection (2) below, the rate at which tax is charged under section 64 above at any time shall be three tenths of the effective rate (that is to say the rate found by expressing the tax chargeable as a percentage of the amount on which it is charged) at which tax would be charged on the value transferred by a chargeable transfer of the description specified in subsection (3) below.*
- (2) *Where the whole or part of the value mentioned in section 64 above is attributable to property which was not relevant property, or was not comprised in the settlement, throughout the period of ten years ending immediately before the ten-year anniversary concerned, the rate at which tax is charged on that value or part shall be reduced by one-fortieth for each of the successive quarters in that period which expired before the property became, or last became, relevant property comprised in the settlement.*

It can be seen that the rate is determined by reference to a notional transfer of value, with a reduction for so much of the ten year period as the settled property was not relevant property or comprised in the settlement. This will be relevant to those settlements brought within the relevant property regime by FA 2006.

The notional transfer of value is treated as a lifetime transfer of value. As such, it is taxed at a rate of 20% insofar as it exceeds the available nil rate band of the notional transferor. If there is no available nil rate band, the rate would be 6% (3/10ths of 20%). That is the maximum rate at which the ten year anniversary charge can be applied.

The remaining provisions of the section relate to calculating the notional transfer of value. I have not set out these provisions, but have attempted to explain their effect.

Two figures of particular importance in determining the tax charge will be that for the value transferred on the notional transfer of value, and that for the available nil rate band on the notional transfer of value.

The value transferred by the notional transfer of value will be the total of the following:

- (i) the value of the property in the settlement (including any property which is

not relevant property); and

- (ii) the value of any property in a non charitable settlement created by the same settlor on the same day.

It can be seen where there is more than one settlement for inheritance tax purposes, the notional transfer of value will be split among them, thereby potentially reducing the ten year charge.

In determining the available nil rate band on the notional transfer of value (which will be available in respect of each deemed settlement), the nil rate band on the date of the charge (£300,000 at present) is reduced by whichever is the greatest of the value of chargeable transfers made by the settlor in:

- (i) the seven years before the date of the commencement of the deemed settlement (disregarding transfers made on that day); and
- (ii) the seven years before each date on which property was added to the settlement (disregarding transfers made on that day and transfers made to the settlement).

This will require separate calculations to be made for each day on which property was added to the settlement. Since, however, it is assumed that potentially exempt transfers will prove to be exempt (section 3A(5) IHTA 1984) these can be left out of account (unless they become chargeable by the death of the settlor within the seven year period).

The available nil rate band will also be reduced by the value of property leaving the settlement in the previous ten years.

The effective rate will be the amount of tax charged on the notional transfer (20% x (notional transfer of value less the notional nil rate band)) expressed as a percentage of the notional transfer of value. The rate on the ten year anniversary will be 3/10ths of this, reduced insofar as property has not been relevant property for the entire period.

It is noted that, because exit charges are based upon the value of trust property immediately after the settlement commenced, or at the previous ten year anniversary, while ten year anniversary charges are based upon the value of trust property at that time, the exit charge which would apply immediately before a ten year anniversary may be very different for the subsequent ten year anniversary charge: see sections 66 to 69 IHTA 1984.

This will only be relevant where it is contemplated that property will cease to be settled property. As stated above, where property moves between settlements, it is

treated by virtue of section 81 IHTA 1984 as remaining comprised in the first settlement for the purposes of calculating 10 year charges and exit charges.

In any event, it can be seen that ten year charges and exit charges will depend upon the particular circumstances of the settlement. Since a 6% charge is likely to be of greater concern than a 0.2% charge it will be necessary in each case to consider how the circumstances of a particular settlement are relevant.

A 'qualifying interest in possession' insofar as individuals are concerned is now defined in section 59(1) IHTA 1984 in the following terms:

- (1) *In this Chapter "qualifying interest in possession" means-*
  - (a) *an interest in possession-*
    - (i) *to which an individual is beneficially entitled, and*
    - (ii) *which, if the individual became beneficially entitled to the interest in possession on or after 22nd March 2006, is an immediate post-death interest, a disabled person's interest or a transitional serial interest, or*
  - (b) *an interest in possession to which, where subsection (2) below applies, a company is beneficially entitled.*

This corresponds to the interests in possession to which section 49(1) IHTA 1984 continues to apply (I shall refer to such as a 'Section 49 IIP' as opposed to 'non-qualifying IIP'):

#### ***49 Treatment of interests in possession***

- (1) *A person beneficially entitled to an interest in possession in settled property shall be treated for the purposes of this Act as beneficially entitled to the property in which the interest subsists.*
- (1A) *Where the interest in possession mentioned in subsection (1) above is one to which the person becomes beneficially entitled on or after 22nd March 2006, subsection (1) above applies in relation to that interest only if, and for so long as, it is-*
  - (a) *an immediate post-death interest,*
  - (b) *a disabled person's interest, or*



- (c) *a transitional serial interest.*
- (1B) *Where the interest in possession mentioned in subsection (1) above is one to which the person became beneficially entitled before 22nd March, subsection (1) above does not apply in relation to that interest at any time when section 71A below applies to the property in which the interest subsists.*
- (2) *Where a person becomes entitled to an interest in possession in settled property as a result of a disposition for a consideration in money or money's worth, any question whether and to what extent the giving of the consideration is a transfer of value or chargeable transfer shall be determined without regard to subsection (1) above.*

Similarly, it can be seen from section 5(1) and (1A) IHTA 1984 that a non-qualifying IIP (which can be a valuable right) is left out of account in having regard to a person's estate:

- (1) *For the purposes of this Act a person's estate is the aggregate of all the property to which he is beneficially entitled, except that-*
  - (a) *the estate of a person-*
    - (i) *does not include an interest in possession in settled property to which section 71A or 71D below applies, and*
    - (ii) *does not include an interest in possession that falls within subsection (1A) below, and*
  - (b) *the estate of a person immediately before his death does not include excluded property.*
- (1A) *An interest in possession falls within this subsection if-*
  - (a) *it is an interest in possession in settled property,*
  - (b) *the settled property is not property to which section 71A or 71D below applies,*
  - (c) *the person is beneficially entitled to the interest in possession,*
  - (d) *the person became beneficially entitled to the interest in possession on or after 22nd March 2006, and*

- (e) *the interest in possession is-*
  - (i) *not an immediate post-death interest,*
  - (ii) *not a disabled person's interest, and*
  - (iii) *not a transitional serial interest.*

Whether it is advantageous from an inheritance tax point of view to have a Section 49 IIP or a non qualifying IIP is likely to depend upon the particular circumstances of the trust.

Where the beneficiary in question is relatively young and with a long life expectancy, then it is likely to be beneficial to have a Section 49 IIP. Although the settled property is deemed to form part of the beneficiary's estate, it is unlikely to be subject to an inheritance tax charge for some significant time, and further planning might in any event be adopted in the future. Furthermore, suitable insurance might be obtained.

This is especially the case where ten year charges are likely to be close to 6%, as is more likely to be the case with interest in possession trusts created before 22 March 2006, where planning to mitigate the relevant property charges was not an issue.

Where ten year charges are (at least initially) much lower, the advantage is somewhat less. The rate of such charges will, however, increase where the value of the trust fund increases at a greater rate than the nil rate band.

Where a beneficiary has a relatively low life expectancy, the non-qualifying IIP may very well be preferred. The interest does not form part of the beneficiary's estate and as such will escape tax on his death. Further, the trustees can be more flexible in appointing different trusts for different beneficiaries.

### ***Interests in possession existing before 22 March 2006***

The circumstances in which a Section 49 IIP can exist are limited. Obviously, one such circumstance is where an interest in possession was created before 22 March 2006.

Where such an interest in possession exists, the trustees will have decide whether to leave matters as they are, appoint new transitional serial interests, or bring the trust fund into the relevant property regime.

This will obviously depend upon the circumstances of the life tenant, other potential beneficiaries, and the nature and value of the trust fund.

An important consideration to be born in mind in bringing any Section 49 IIP to an end will be section 102ZA FA 1986:

***102ZA Gifts with reservation: termination of interests in possession***

(1) *Subsection (2) below applies where-*

- (a) *an individual is beneficially entitled to an interest in possession in settled property,*
- (b) *either-*
  - (i) *the individual became beneficially entitled to the interest in possession before 22nd March 2006, or*
  - (ii) *the individual became beneficially entitled to the interest in possession on or after 22nd March 2006 and the interest is an immediate post-death interest, a disabled person's interest or a transitional serial interest, and*
- (c) *the interest in possession comes to an end during the individual's life.*

(2) *For the purposes of-*

- (a) *section 102 above, and*
- (b) *Schedule 20 to this Act,*

*the individual shall be taken (if, or so far as, he would not otherwise be) to dispose, on the coming to an end of the interest in possession, of the no-longer-possessioned property by way of gift.*

(3) *In subsection (2) above “the no-longer-possessioned property” means the property in which the interest in possession subsisted immediately before it came to an end, other than any of it to which the individual becomes absolutely and beneficially entitled in possession on the coming to an end of the interest in possession.*

It might be asked what is meant by “the interest in possession comes to an end”. What is the consequence of a disposal of an interest in possession or of a part of it?

In any event, this has the consequence that it is unlikely to be beneficial to replace a Section 49 IIP with a non-qualifying IIP for the same beneficiary unless the relevant

property regime is not an issue.

### ***Transitional serial interests***

Another circumstance in which a Section 49 IIP can exist which is relevant for present purposes is where it is a 'transitional serial interest'. (I shall not consider immediate post death interests or disabled persons interests.)

This provides a short term opportunity for trustees to appoint a Section 49 IIP for another (possibly younger) beneficiary as a means of deferring the application of the relevant property regime.

The creation of such a transitional serial interest requires that some person had an interest in possession in settled property prior to 22 March 2006. As such, its ambit is limited.

A transitional serial interest can be created in one of three ways.

#### ***(i) Section 49C – interests created before 5 April 2008***

Section 49C provides:

#### ***49C Transitional serial interest: interest to which person becomes entitled during period 22nd March 2006 to 5th April 2008***

- (1) Where a person ("B") is beneficially entitled to an interest in possession in settled property ("the current interest"), that interest is a transitional serial interest for the purposes of this Chapter if the following conditions are met.*
- (2) Condition 1 is that-*
  - (a) the settlement commenced before 22nd March 2006, and*
  - (b) immediately before 22nd March 2006, the property then comprised in the settlement was property in which B, or some other person, was beneficially entitled to an interest in possession ("the prior interest").*
- (3) Condition 2 is that the prior interest came to an end at a time on or after 22nd March 2006 but before 6th April 2008.*
- (4) Condition 3 is that B became beneficially entitled to the current interest at that time.*

(5) Condition 4 is that-

- (a) section 71A below does not apply to the property in which the interest subsists, and
- (b) the interest is not a disabled person's interest.

Several difficulties would appear to arise in seeking to apply this provision. In particular, it will only be the most simple and straightforward of settlements which can rely on this provision with any certainty.

#### *Condition 1*

Condition 1 requires that some person was beneficially entitled on 22 March 2006 to an interest in possession in *'the property then comprised in the settlement'*. While the reference to *'some other person'* would seem to include *'some other persons'* (so that there could be multiple persons enjoying interests in possession in the settlement) there would seem to be a very significant problem where a fund or funds of the settlement were held in discretionary or accumulation and maintenance trusts. In that case it cannot be said that a person or persons are beneficially entitled to an interest in possession in property comprised in the settlement. As such, the condition would not be satisfied.

Further, section 81 IHTA 1984 will not apply for the purposes of this section. As such, care should be taken where it is sought to create a transitional serial interest if the trust fund has already been transferred to a separate settlement. A transitional serial interest can, however, be created in the course of transferring property between settlements.

It is noted that there is no requirements as to the status of the original interest in possession or of the person beneficially entitled to it.

#### *Condition 2*

Condition 2 requires that the prior interest comes to an end. This would seem to require the entirety of the interests come to an end.

If A has an interest in possession in both fund X and fund Y (so that Condition 1 is satisfied on any view), and B is appointed an interest in possession in fund X only, then condition 2 would arguably not be satisfied. The 'prior interest', being the interests in funds X and Y has not come to an end.

It is noted that the interest in possession can come to an end in any way, including an appointment or transfer to a different settlement. Further, a disposal of an interest in possession is treated for the purposes of the section as a coming to an end of the

interest: section 51(1)(b) IHTA 1984.

### *Condition 3*

Condition 3 appears to require that all of the old interests must come to an end at the same time as all of the new interests are created. Taking the above example, if B is appointed an interest in possession in Fund Y the day after being appointed the interest in possession in Fund X, condition 3 would not seem to be satisfied.

### *Condition 4*

For section 71A to apply, the interest in possession must be for a person who has not attained the age of 18, and at least one of whose parents has died. Further, the trusts must be established under the will of a deceased parent or under the Criminal Injuries Compensation Scheme.

If the interest is a disabled person's interest, then although the interest in possession will not be a transitional serial interest, it will be a section 49 IIP in any event.

### *Overview*

Unfortunately, it is a recurring deficiency in the drafting of the alterations to IHTA 1984 introduced by Finance Act 2006 that there is a very static and simplified view of what a settlement is and how trusts operate in practice.

While it is certainly arguable that a wider more purposive approach should be adopted to the interpretation of this provision so that one applies it to individual funds, and not entire settlements, it cannot be assumed that such an approach would be accepted, particularly given the relatively clear wording of the section. Unfortunately, there is unlikely to be any decision on the matter before 5 April 2008.

Clearly, attempting to take advantage of this section in all but the simplest of trusts will be a risk. The trustees will have to weigh that risk against the benefits to be obtained on an individual basis.

### *(ii) Section 49D – interests created after 5th April 2008*

Section 49D provides:

**49D** *Transitional serial interest: interest to which person becomes entitled on death of spouse or civil partner on or after 6th April 2008*

(1) *Where a person ("E") is beneficially entitled to an interest in possession in settled property ("the successor interest"), that*

*interest is a transitional serial interest for the purposes of this Chapter if the following conditions are met.*

- (2) *Condition 1 is that-*
  - (a) *the settlement commenced before 22nd March 2006, and*
  - (b) *immediately before 22nd March 2006, the property then comprised in the settlement was property in which a person other than E was beneficially entitled to an interest in possession (“the previous interest”).*
- (3) *Condition 2 is that the previous interest came to an end on or after 6th April 2008 on the death of that other person (“F”).*
- (4) *Condition 3 is that, immediately before F died, F was the spouse or civil partner of E.*
- (5) *Condition 4 is that E became beneficially entitled to the successor interest on F’s death.*
- (6) *Condition 5 is that-*
  - (a) *section 71A below does not apply to the property in which the successor interest subsists, and*
  - (b) *the successor interest is not a disabled person’s interest.*

### *Condition 1*

For the most part, the same considerations as for Condition 1 in section 49C IHTA 1984 will apply. However, in the context of this provision, it would seem necessary that a single person was entitled to an interest in possession in all of the property comprised in the settlement.

It is therefore arguable that this provision will not apply if the settlement included a discretionary fund or more than one person enjoyed an interest in possession in the trust property. The contrary argument is that one takes a purposive approach and applies the section to each individual fund as if such fund were a separate settlement.

### *Condition 2*

Unlike the position under section 49C IHTA 1984, the interest must come to an end on the death of the person entitled, and no other way. If it is sought to place reliance on this provision, it will be necessary to take care to ensure that F retains the same

interest in possession from 22 March 2006 until death. This is likely to require a good deal of care being taken with any appointments.

### *Condition 3*

It is noteworthy that the relationship of spouse or civil partner must exist immediately before death and not on 22 March 2006.

### *Condition 4*

Once again, E need only become beneficially entitled to the successor interest of F's death. This can potentially be satisfied by a suitable appointment made *after* 22 March 2006.

### *Condition 5*

This was considered above.

Although the section has a narrower application, the risks involved in creating this type of transitional serial interest (as opposed to doing nothing) are relatively minimal.

### **(iii)     *Section 49E – interests in contracts of life insurance***

Section 49E IHTA 1984 contains a third type of transitional serial interest which applies in respect settlements which included on 22 March 2006 rights under a contract of life insurance in which a person had an interest in possession. Given the relatively limited application of what is an overly complicated section, and the space constraints of this article, I have not considered it.

### ***When does an interest come to an end?***

An issue which has become of central importance following the introduction of a parallel regime for the taxation of interests in possession relates to how one distinguishes one interest in possession from another.

Is an interest in possession independent of the property in which it subsists? Does it depend upon the legal right giving rise to it? When, and to what extent can alterations in that legal right give rise to a new interest?

Unfortunately (and unsurprisingly) little thought has been given to such issues, with the result that a great deal of uncertainty arises in trying to apply the legislation and in simply trying to deal with existing settlements.

One possibility is that one looks at settled property and considers the rights which



attach to that settled property, or property replacing it from time to time. So long as such rights give rise to an interest in possession, then the same treatment applies, regardless of whether those rights derive from the original trust document, a subsequent appointment, a statutory provision or a different settlement to which the settled property has been added.

Further, where additional property is added to the trust, although the rights in respect of such property might derive from the same document, one considers the rights separately by reference to that new settled property.

This approach has the benefit of being relatively straightforward to apply. The nature of an interest in possession can be determined by a quasi tracing exercise. As long as a person enjoys the same rights in respect of property, the tax treatment remains the same.

Additionally, this avoids the situation where as a result of a technical rule of trust law a person is treated as having made a chargeable lifetime transfer which is also deemed to be a gift with reservation of benefit despite enjoying no substantive change in his rights to trust property.

The difficulty with this approach, however, is that the reference to B in section 49C(2)(b) IHTA 1984 appears to contemplate that a transitional serial interest can arise to the same person as was entitled to the original interest. Further. Section 53(2) IHTA 1984 contemplates the possibility of a person becoming entitled to 'another interest in possession' in the same property in respect of which a previous interest in possession ceased.

While I consider that the correct approach is likely to be to look to the settled property to determine the treatment of the interest, there clearly is some ambiguity. Until the matter is resolved, it will clearly be necessary to take care in how any changes to a Section 49 IIP are made.

It may also be prudent to consider the terms of any interest in possession where the basis of the right to income may change (e.g. where a beneficiary has a contingent life interest, but in the meantime is entitled to the intermediate income of the fund). While it is by no means the case that there would most certainly be a problem, the issue can be avoided by creation of a suitable long term transitional serial interest before 5 April 2008.

### ***Adding property to a Section 49 IIP***

If an interest in possession is distinguishable and separate from the settled property in which it subsists, then an argument might be made that by introducing property to the settlement, so that it is subject to that same interest, then the same inheritance tax treatment should follow. Accordingly, by adding property to the funds of a Section

49 IIP that property would also be treated as part of the Section 49 IIP, and not as subject to a non-qualifying interest in possession.

This would be a very surprising result and one which would seem to be contrary to the general scheme of the new legislation. In any event, it would not seem to apply where the property is added by a different settlor (section 44(2) IHTA 1984).

A preferable solution will be to gift property in a way which increases the value of settled property held by the trustees rather than gifting new settled property to the trustees. Such a gift would also seem to be a potentially exempt transfer (see section 3A(2)(b) IHTA 1984).

### ***An overly technical approach?***

It has been pointed out that in answers to questions submitted by The Chartered Institute of Taxation and The Society of Trust and Estate Practitioners in 7 September 2006, HMRC appear to accept a much less technical approach to the application of these provisions. On this basis, it might be considered that the above concerns are immaterial.

There are of course, two points which arise from this. Firstly, any reliance placed upon the terms of a HMRC statement will not provide a defence to a legal challenge. The Courts will not uphold a concession or a statement of practice where such concession or statement of practice does not represent the strict legal position (see *Smith v HMRC* (2007) SpC 605 for a recent statement of this in the context of inheritance tax).

This leads to the second point, namely the extent to which HMRC can be bound to a view which they have expressed and which does not represent the law. While it might be sought to bind HMRC by way of judicial review on the basis that a statement has created a legitimate expectation, it is by no means certain that HMRC will be bound, even where unfairness has resulted (see for example *R (on the application of Bamber) v Revenue and Customs Commissioners* [2006] STC 1035).

This then leads one to a consideration of the extent to which HMRC will consider itself bound by a statement. It is unlikely that it will consider itself bound in any case involving tax avoidance, which in certain circumstances can be interpreted by HMRC to include what might be considered to be relatively basic tax planning.

In this respect it is noted that HMRC are already taking the entirely unmeritorious argument (which is wrong in any event) that the replacement with one section 49 IIP in the favour of an individual by a second section 49 IIP in favour of the same individual will be a transitional serial interest which gives rise to a charge to tax on the settled property under section 53(2A) IHTA 1984 despite no change in the individual's estate. As well as being contrary to the general content of their earlier

correspondence, this illustrates a willingness to adopt a technical approach to the interpretation of the new legislation.

Accordingly, it is my view that although the published statements on this area offer a good deal of comfort, they do no more than that. Certainly, they do not enable one to disregard the risks inherent in adopting a transitional serial interest in all but the most simple of circumstances, albeit that they do reduce the extent of those risks.

### **Accumulation and maintenance trusts**

Section 71(1) to (1B) IHTA 1984 currently provides:

- (1) Subject to subsections (1A) to (2) below, this section applies to settled property if-*
  - (a) one or more persons (in this section referred to as beneficiaries) will, on or before attaining a specified age not exceeding twenty-five, become beneficially entitled to it or to an interest in possession in it, and*
  - (b) no interest in possession subsists in it and the income from it is to be accumulated so far as not applied for the maintenance, education or benefit of a beneficiary.*
- (1A) This section does not apply to settled property at any particular time on or after 22nd March 2006 unless this section-*
  - (a) applied to the settled property immediately before 22nd March 2006, and*
  - (b) has applied to the settled property at all subsequent times up to the particular time.*
- (1B) This section does not apply to settled property at any particular time on or after 22nd March 2006 if, at that time, section 71A below applies to the settled property.*

From 6 April 2008 subsection (1) will be amended to provide as follows:

- (1) Subject to subsections (1A) to (2) below, this section applies to settled property if-*
  - (a) one or more persons (in this section referred to as beneficiaries) will, on or before attaining a specified age*

*not exceeding **eighteen**, become beneficially entitled to it, and*

- (b) *no interest in possession subsists in it and the income from it is to be accumulated so far as not applied for the maintenance, education or benefit of a beneficiary.*

No charge to inheritance tax will arise on the coming into force of the amended subsection (1) if the unamended subsection would have applied at that time: paragraph 3(3) Schedule 20 Finance Act 2006.

### ***Options available to trustees***

There are a number of options available to the trustees, although clearly the desirability of each will depend upon

- (i) when a ten year charge will arise and
- (ii) how much (a) that 10 year charge and (b) any exit charge shortly preceding it will be.

The size of the fund, age of the beneficiaries and maturity of the beneficiaries will also be very relevant factors.

Each of the following presupposes that it is possible as a matter of trust law for the trustees to take the steps envisaged. This is unlikely to be a straightforward matter for any accumulation and maintenance trust, and will require consideration on a case by case basis.

- (i) *Amend so that beneficiary becomes entitled at 18*

It would be necessary to make such an amendment by 6 April 2008. The beneficiaries will necessarily have to be under the age of 18 at that time.

Clearly, the tax saving achieved using this approach will need to be weighed against the disadvantage of restricting flexibility and therefore the trustees' options in the future. If the beneficiaries are young enough to enable this approach to be adopted, it may be the case that such flexibility will be more necessary in the future. That is to say, that the trustees will be unlikely to be in a position to judge the maturity of the beneficiaries when they attain 18.

- (ii) *Appoint absolutely*

Where the beneficiaries are under the age of 18, appointing bare trusts with an extended statutory power of advancement is likely to be a preferable solution for

inheritance tax purposes to arranging matters so that section 71 IHTA 1984 continues to apply.

It is relatively clear that the statutory power of advancement can apply to funds held for a minor absolutely: see *CD (a minor) v O* [2004] EWHC 1036 per Lloyd J at para 11. As such, the trustees will retain a degree of flexibility over the trust property, and indeed could settle it on trust if that was for the benefit of the beneficiary.

Further, a bare trust is not a settlement for purposes of IHTA 1984. As such, the relevant property regime will not apply.

The property will form part of the beneficiary's estate and therefore subject to inheritance tax on death.

Clearly capital gains tax could be an issue with such an approach and no appointment should be made without considering trust gains and unrealised gains.

*(iii) Accept the application of the relevant property regime*

If nothing is done so that section 71 ceases to apply trust fund will become relevant property for the purposes of section 58 IHTA 1984 from 6 April 2008.

One option is obviously to accept this state of affairs, particularly if the potential charges are likely to be a relatively low rate.

If this approach is to be adopted, it will likely be beneficial to dismantle the accumulation and maintenance trusts after 6 April 2008 to take advantage of the greater flexibility which the relevant property regime offers.

*(iv) Appoint trusts to which the relevant property regime does not apply*

It may be possible from 6 April 2008 to appoint trusts which avoid the application of the charge to inheritance tax on relevant property. One means by which this might be achieved would be to bring them within the restricted section 71(1) IHTA 1984 as set out above.

Another option, however, would be to take steps so that the trusts qualify for relief under section 86 IHTA 1984 (employee trusts) albeit that they would also have to satisfy the restrictions in section 58(1A) to (1C) IHTA 1984.

The ability to adopt such an approach is likely to depend upon the terms of the trust, and in particular, the ability to add to the class of beneficiaries.

Another less controversial option which might be adopted for an accumulation and

maintenance trust would be to convert it to an age 18 to 25 trust by altering the terms so that it came within section 71D IHTA 1984. This is expressly permitted by section 71D(3) IHTA 1984.

I do not, however, consider that this will be an advisable course in most cases. This is because the charge under section 71E IHTA 1984 on property leaving the trust will be broadly the same as if the property had been relevant property during the period section 71D IHTA 1984 applied to the settlement. As such, there is no particular tax saving, while the requirements of the section make the trust much less flexible.

### **Discretionary trusts**

One consequence of the extension of the relevant property regime is that a great deal of flexibility has been added to trusts which were previously subject to it.

In particular, trustees can now give interests in possession to beneficiaries of relevant property trusts without giving rise to any particular inheritance tax consequences. This can be of use, whether as a matter of providing security or for the more straightforward income tax treatment which applies.