HIGHLIGHTS OF "CAPITAL TAX PLANNING AFTER THE BUDGET BOMBSHELL"

A Key Haven Conference held on 7th November 2006

Speakers:
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(All statutory references are to the Inheritance Tax Act 1984 as amended unless otherwise stated)

1 Presentation summarised at page 1 in this issue.

2 Presentation summarised at page 15 in this issue.

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I Overview of recent changes to United Kingdom capital taxation – Robert Venables QC

New Recognised Interests in Possession

New interests in possession, i.e. those to which a person becomes beneficially entitled after 21st March 2006, will be Recognised Interests in Possessions (i.e. broadly treated in the same way as pre-22nd March 2006) **only** if they fall into one of three categories:

(a) an immediate post-death interest – s49A

(b) a transitional serial interest, which can be any one of three different types; and

(c) a disabled person's interest – see s89B(1).

Robert explained that such a disabled trust can be perverse, in that the relevant property, discretionary trust, regime may be preferable, especially as the assets do not form part of the beneficiary's estate.

For the Three Types of Transitional Serial Interest – see new s49B, 49C, 49D and 49E.

Overview – One Door Closes, Another Opens

While the life of the tax planner has in many ways been made more difficult by Finance Act 2006, the incompetence of the drafting opens up some new opportunities which have not been available before.
For example, it is now possible in general for a person to create a settlement at virtually any time during their life under which they can benefit throughout their life *without:*

- the creation of the settlement involving any transfer of value, even a potentially exempt transfer;

- the settled property being brought into charge on their death, whether on normal principles or on account of the Gifts with Reservation of Benefit Provisions;

- the settled property suffering any ten-year or exit charges to inheritance tax;

- being subject to any charge under the Previously Owned Assets Provisions.

Moreover, a recognised interest in possession can in general be brought to end, even on the deathbed of the beneficiary, without any charge to inheritance tax either on the settled property or on the death of the beneficiary.

But for Finance Act 2006, each of these would have been inconceivable!

Avoiding Creating a "Settlement"

It is always possible to create a simple trust which is not a "settlement" (e.g. bare trusts). However that is unlikely to be a satisfactory alternative in most cases.

Highly sophisticated taxpayers may prefer to use foreign institutions, such as the *Liechtenstein Trust Enterprise* with legal personality, which they are advised do not constitute a "settlement" for inheritance tax purposes. While that course may well be highly effective in inheritance tax terms, and quite possibly, in capital gains tax terms, there are other considerations which need to be taken very carefully into account.

Settlements of assets likely to appreciate in value

Settlement of assets likely to appreciate in value were stressed by Robert including settling assets the present value of which is low but which are likely to appreciate considerably in value. Shares in start-up companies are an obvious example. In the case of established companies, it may be appropriate to create a class of *deferred shares* by means of a "reorganisation" within the capital gains tax rules and to gift those. *Reversions* expectant on the termination of leases at low rents are also suitable. *Intellectual property* which has a low value now but which may become very valuable in future could also be a candidate.

Sometimes it will be appropriate to fragment an existing asset into complementary wasting and appreciating assets and to gift the appreciating asset. In that case, however, the long term capital gains tax consequences should be carefully considered.

Use of the Normal Expenditure Out of Income Exemption – s21

A settlor could set up a number of "pilot" relevant property trusts with small amounts and fund them principally by gifts which qualify for the normal expenditure out of income.

This will often be particularly appropriate in the case of an expatriate settlor who is still domiciled (or deemed domiciled) in the United Kingdom and who has a large income on which he pays only modest income taxes.

Use of Excluded Property Rules: Settling of Reversionary Interest – s48

A reversionary interest in property comprised in an existing settlement will often constitute excluded property for inheritance tax purposes, so that a gift of it will not give rise to a transfer of value. It might therefore be thought appropriate to gift such an interest to several relevant property trusts before it fell into possession.

It may be possible to effect a ***variation*** of the estate of a deceased person falling within *section 142* which involves the creation of a relevant property trust, which is therefore deemed to have been created by the deceased.

Use of Employee Trusts

Reference to s86 and the opportunity of benefiting members of the family. (See also Robert's article "Post *Dextra* Tax Planning" in PTPR Volume 11, Issue 1).

II What to do with Pre-Budget Trusts after FA2006 - Timothy Lyons QC

Pre-22 March 2006, much settled property was *not relevant property*. Now newly settled property will most often fall within the relevant property regime. Timothy commented that it is at first sight extraordinary that in FA 2006, the Chancellor has achieved what tax planners so often aim for e.g. that the trust fund does not form part of the beneficiaries' estate.

The regime governing *potentially exempt transfers* was broadly drawn. Now it is more narrowly drawn with a bias towards gifts between absolute owners. But the legislation still encourages lifetime giving.

Is there an attack on trusts?

One may think that it is in the government's interest that trusts be used so that the new provisions raise some tax. The calculation presumably is that a good number of families over a certain wealth bracket will be prepared to pay tax to maintain the trusts they want. It may be that the new IHT regime is an attack on trusts in the same way that increases in duty are an attack on smoking.

Existing interest in possession trusts

As a general rule, those who were entitled to interests in possession before 22nd March 2006 retain the treatment provided by section 49(1). The interest in possession is within their estate and inter spouse/civil partner exemption can apply. Note, however, that the new regime for trusts for bereaved minors (s.71A) and the new 18-to-25 trusts in (IHTA 1984 section 71D) apply to settled property which was settled before 22nd March 2006 (see sections 71A(1) and 71D(1)). There is a specific exclusion from the 18-to-25 trust regime where a person became beneficially entitled to an interest in possession before 22nd March 2006 (see section 71D(5)(c)). There is not a similar exclusion, in Section 71A, in relation to interests in possession in trusts for bereaved minors. IHTA 1984 section 49(3) provides that where a person became entitled to an interest in possession before 22nd March 2006 then section 49(1) does not apply when section 71A does: see IHTA 1984 section 49(1B).

The advantages of the pre-existing life interest

The person who became entitled to an interest in possession before 22nd March 2006 is now in a privileged position. The assets can remain settled and subject to all the provisions of the settlement, including overriding powers, without falling within the relevant property regime. What one does about that situation rather depends upon the age of the individual who is entitled.

(a) *Do nothing?*

If the individual is young then there may be an argument, in some cases, for doing nothing at all and waiting for a new regime to come along.

(b) *Appoint out?*

On the other hand, if it is correct that PETs may not be with us for ever, then it may be appropriate to make a PET now. The trustees may exercise an overriding power of appointment to remove an individual's interest in possession and give the property to another individual absolutely to deal with as they wish.

The interest in possession is terminated and tax is charged as if the person beneficially entitled to the interest in possession had made a transfer of value: see section 52(1). Where the person becomes beneficially entitled to the interest *on or after* 22nd March 2006 this is so only where the interest terminated is an immediate post-death interest, a disabled person's interest or a transitional serial interest: section 52(2A).

The termination in relation to pre-existing trusts constitutes a PET.

(c) *Transitional serial interests? ("TSI")*

If one does not want to leave the existing life interest in place or make a PET by giving the property to someone absolutely, then one may want to create a TSI. (It is possible to replace a person's interest in possession with a different, perhaps much longer, TSI if that is required).

The TSI is, of course, one of the interests which ensures that property stays outside the relevant property regime (see section 49(1A)). That being so, a transfer into it will also be a PET.

Existing A & M Trusts

Section 71 also does not apply after 22nd March 2006 unless it has applied to the settled property immediately before 22nd March 2006 and has applied to the settled property at all times thereafter. A & M trusts are privileged. One cannot drop in and out of the privileged regime. One cannot create new A & M trusts now within section 71 FA 2006 Sch 20 para 3, states that as from 6th April 2008, the age of twenty-five is to be substituted for the age of eighteen and the reference to a person becoming entitled to an interest in possession at that age is deleted. The conditions of section 71 will, therefore, require absolute entitlement at 18. The paragraph comes into force on 6th April 2008 only for the purpose of determining whether section 71 applies to property on or after that day. If there is a failure to meet the new requirements of section 71 but the trust would otherwise fall within it, there is to be no exit charge under section 71(3): see Schedule 20 paragraph 3. Nevertheless, it will be settled property outside the protected regime and in the relevant property regime.

Section 71D provides that **the 18-25 regime** will apply to property notwithstanding the trust is **not set up on death.** It is necessary for the property to be held on trust for a person who has not attained 25 years of age and for the trusts to satisfy the trust requirements of 18-to-25 trusts in section 71D(3), very roughly, these may be said to be absolute entitlement at 25 and entitlement to the income before then.

III Will Trusts and variations after FA 2006 – G Robert A Argles

- There is a **window of opportunity** where interests in possession are concerned.

(a) Where the testator has failed in the will to make use of the nil rate band and has instead given or settled his estate on trust for his spouse, the nil rate band property should under as deed of variation (since the spouse will be able to dispose of his or her interest) be settled on trusts for the benefit of persons other than the spouse. (Section 144 is of little use here because it only applies where the property initially is relevant property). Moreover, since the deed of variation is treated as being made by the testator and not by the surviving spouse of the testator, the provisions of section 102ZA Finance Act 1986 will not result in any reservation of benefit problems for the surviving spouse in the "relevant property". So in principle there is no objection to including her or him as one of the class of beneficiaries taking under a discretionary trust regime constituted by the variation.

Therefore it is still possible to recast the trusts of the will of a testator who died before the 22nd March 2006 – or indeed on or after that date – so as to produce a more favourable result than that which would pertain if the trusts declared by the will took effect (section 142 and 144, IHTA).

Where all the beneficiaries under the will are adult and in being this would normally be done by a deed of variation taking effect under section 142. The key points about such deeds are that they must be made within two years of the death and that they speak from the death so the variation now made will be treated as if it had been made before the 22nd March 2006 and any trusts created will be treated as if they already subsisted on that date.

Section 144 which is not dependent on the willingness of the beneficiaries to join in a variation or whether they are infants or unborns is likely to prove the more useful. Like section 142 variations, the appointment must be made within two years of the death and take effect as if it had been made in the will.

Variations and appointments present the will beneficiaries and trustees with an opportunity, albeit a limited opportunity to rewrite the dispositions declared by the will in the light of the FA 2006 changes.

Care should be taken to ensure that the spouse in such cases is not treated as having acquired an interest in possession in the family home by exercise of a power of the trustees to allow him or her to live in the home. The trustees should postpone exercise of this power so as to avoid creating an immediate post-death interest and ensure that the right to occupy takes effect from some time after the death. The facts surrounding the spouse's occupation of the family home need to be carefully reviewed.

(b) Correspondingly the powers of appointment to which section 144 refers can still be used so as to secure for the estate the benefit of the spouse exemption where the property would otherwise be the subject of a chargeable transfer of value on the testator dying before the 22nd March 2006. As to deaths on or after that date, the interests conferred on the surviving spouse by the variation or appointment must be an "immediate post death interest". But in the case of death prior to the 22nd March, an interest in possession conferred by a variation on the surviving spouse is subject to the old rules. The conferment of interest in possession on the surviving spouse will cause the property subject to that interest to be comprised in his or her inheritance tax "estate". So whilst it is exempt on the death of the testator (section 18) it will be the subject of a charge on the death of the subsequent spouse. In this context Robert referred to the application of TSI under 49D.

If the existing house is sold because it is too big and the will trustees then purchase a further house under their powers in the will which they thereafter permit the surviving spouse to occupy, it might be expected that the interest which he or she then enjoys was either a continuation of the original "interest" or at least a transitional serial interest. Unfortunately section 49C, IHTA leaves little room for doubt that unless the change takes place before the 6th April 2008 the interest in the new house will not be a transitional serial interest and the downsizing operation involved will result in the surviving spouse being deemed to make a chargeable transfer of value on the property becoming relevant property.

If the former life tenant who occupied the home which has been sold is once again permitted by the trustees to occupy the new home purchased out of the proceeds, the interest will not qualify under one or other of these headings and the property will be "relevant property." In such circumstances the former life tenant will be treated as having "reserved a benefit" within the meaning of the new section 102ZA Finance Act 1986 (introduced by Schedule 20, paragraph 33, FA 2006).

(c) Regard should be had to the nature of the property: in particular *relevant business property and the agricultural value* of agricultural property and excluded property may well be the subject of a nil transfer of value. Such assets can sensibly be regarded as assets which should be held as relevant property in a discretionary settlement for the benefit of a wide class of persons who can include the spouse and children of the testator. There is an advantage to the will trustees in securing that agricultural, business or indeed most classes of excluded property are held on interest in possession trusts, the terms of which prevent the trust property falling within the discretionary trust regime as "relevant property". These privileged interest in possession trusts are those subsisting before the 22nd March 2006, transitional serial interests, disabled person's interest and "immediately post death" interests.

Given that the charge to inheritance tax on individuals is fixed at 40% on all chargeable transfers over the nil rate band and it will take something in excess of 60 years for the same amount to be charged on relevant property comprised in the discretionary trust, it is more likely that the old style A & M trusts or simple discretionary settlements will find favour with testators rather than the reverse. The advice to be given to intending testators or to will trustees exercising their powers is for the present to avoid bereaved minor trusts and age 18-25 trust. For intending testators the course to be preferred is to confer on the trustees the widest power to appoint amongst a specified class of beneficiaries as the testators can conceive which can be exercised by the trustees following the death of the testator under section 144. This might be accompanied by a letter of wishes given by the testator at the time of the making of the will and varied thereafter as appropriate.

A wide testamentary power is given to trust executors and trustees (including, Robert suggests, the surviving spouse) is one which in many circumstances offers the greatest degree of flexibility and, if accompanied by a letter of wishes, would afford the greatest comfort to the trustees and beneficiaries.

If the trustees and the testators when making their wills wish to avoid the ten year periodic and exit charges whilst preserving the status of the property as settled property this can be done only for a limited period of time as allowed by section 71A (bereaved minors) and section 71D (age 18-25 trusts) IHTA.

***Age 18-25 Trust** (new section 71D)*

These have one advantage and one advantage only, they allow the postponement of the vesting of the trust capital until the beneficiary attains 25 years. Provided the powers which the trustees retain under the A & M will trusts are sufficiently wide, section 71D presents a useful if limited opportunity for preventing trust capital from falling into the hands of an irresponsible beneficiary at too early a time.

Accumulation and Maintenance Trusts

It will no longer be possible to create the old style section 71 A & M and the trusts under wills of testators dying on or after the 22nd March 2006. Accordingly it

will not be possible to vary the trusts whether by appointment or otherwise in respect of such testator's wills so as to include such old style A & M trusts. "Not possible" is not strictly accurate. Such A & M trusts will be relevant property trusts.