

ACCUMULATION AND MAINTENANCE TRUSTS AND THE TWENTY-FIVE YEAR RULE

or

HOW TO AVOID A 21% CHARGE ON CAPITAL

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1 Scope of the Article

In this article, I discuss a rule which prevents accumulation and maintenance trusts qualifying for special inheritance tax treatment after twenty-five years and imposes a swinging charge of 21% of the value of the capital of the settled property. It is a charge which has become operative only since April 2001. There must be many trusts where it is a time-bomb ticking away. If the problem is appreciated in time, it can usually be solved.

2 Advantages of Accumulation and Maintenance Trusts

Accumulation and maintenance trusts falling within Inheritance Act 1984 section 71 qualify for privileged inheritance tax treatment. There is normally no charge to tax on the settled property, even if a beneficiary dies.² Likewise, they can

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² Inheritance Act 1984 section 71(4).

ripen into interest in possession or absolute interest trusts without a charge to inheritance tax. A gift to such a trust qualifies as a potentially exempt transfer.³

Nor is the capital gains tax treatment nowadays unduly unfavourable. Gain realised by the trustees of all United Kingdom resident “settlements” are now taxed at 34%.⁴ True, there is no general holdover relief on gifts available when assets are put into trust, but that is also true of interest in possession trusts. If property ceases to be comprised in an accumulation and maintenance a settlement trust by a beneficiary becoming absolutely entitled, holdover relief is, however, available.⁵

3 Definition

3.1 The Basic Definition

The basic definition is contained in Inheritance Act 1984 section 71(1), which provides:

- “1) Subject to subsection (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.”

3.2 The Twenty-Five Year Rule

It is not surprising that there should be some limitations on the generous treatment afforded by the section. The twenty-five year rule, which was

³ Inheritance Act 1984 section 3A(1)(c).

⁴ That is an advantage if the beneficiaries are wealthy. It is a disadvantage if they have only a modest income and do not exhaust their capital gains tax annual exemption. That, however, is true of all trusts other than bare trusts.

⁵ Under Taxation of Chargeable Gains Act 1992 section 260(2)(d).

introduced by Finance Act 1976,⁶ is now contained in section 71(2), which provides:

- “(2) This section does not apply to settled property unless either-
- (a) not more than twenty-five years have elapsed since the commencement of the settlement or, if it was later, since the time (or latest time) when the conditions stated in paragraphs (a) and (b) of subsection (1) above became satisfied with respect to the property, or
 - (b) all the persons who are or have been beneficiaries are or were either-
 - (i) grandchildren of a common grandparent, or
 - (ii) children, widows or widowers of such grandchildren who were themselves beneficiaries but died before the time when, had they survived, they would have become entitled as mentioned in subsection (1)(a) above”

Often, accumulation and maintenance trust are created for a class of children or grandchildren of a given person, so that the twenty-five year rule is excluded by section 71(2)(b). Quite often, however, it is not. Sometimes, accumulation and maintenance trust are created where there is no “real” beneficiary in existence and a “stooge” beneficiary is “borrowed”, the intention being to cut him out as soon as a member of the “real” class is born. For example, a father might wish to create a settlement for his son’s children on the occasion of the son’s marriage. Prima facie, an accumulation and maintenance settlement would be appropriate. If, however, the son and his fiancée are rather old-fashioned and have not produced any offspring before the marriage, that is not possible as there must be (or have been) at least one member of the class of beneficiaries in existence in order for section 71(1) to apply.⁷ In such a case it might be appropriate to borrow a younger child of the settlor.

In the remainder of this article, I shall assume, unless otherwise indicated, that

⁶ There are special transitional provisions relating to trusts which already qualified on April 15th 1976: see section 71(6).

⁷ See section 71(7) “In subsection (1) above “persons” includes unborn persons; but the conditions stated in that subsection shall be treated as not satisfied unless there is or has been a living beneficiary.”

the trust does not fall within section 71(2)(b).

4 Effect of the Twenty-Five Year Rule

4.1 Not Apply *Ab Initio*

One should first note that the twenty-five year rule does not require that the accumulation and maintenance trusts should come to an end within twenty-five years. A trust still qualifies as an accumulation and maintenance trust from the date of its creation even though it is possible, or even certain, that it will still be in existence in twenty-five years time. The rule is nothing like the common law rule against perpetuities or even the wait-and-see rule under the Perpetuities and Accumulations Act 1964.

4.2 Application to Successive Periods

Secondly, the twenty-five year rule is not a once-and-for-all rule applying on a settlement by settlement basis. Instead, it applies for each period during which the trusts are (otherwise) qualifying accumulation and maintenance trusts. That is made clear by the words in section 71(2)(a) “not more than twenty-five years have elapsed since the commencement of the settlement or, if it was later, since the time (or latest time) when the conditions stated in paragraphs (a) and (b) of subsection (1) above became satisfied with respect to the property”. Thus, if property is settled on trust for A, aged 16 for life, remainder on accumulation and maintenance trusts for a class of beneficiaries and A dies aged 20, there will have been accumulation and maintenance trusts until A attained 18.⁸ From then until his death, there will have been an interest in possession trust. From his death, there will once again be an accumulation and maintenance trusts and in relation to those trusts the twenty-five year period will begin to run again.

4.3 Effect of Rule Applying

When the rule does apply, it applies with a vengeance. There is a charge to tax at the rate of 21% of the settled property.⁹ This will be greater than the periodic charge and exit charges which would have been charged had the settled property been “relevant property”, e.g. because subject to non-privileged discretionary trusts, during that period.¹⁰ This is a crude and unjust charge.

⁸ by virtue of Trust Act 1925 section 31.

⁹ See Inheritance Act 1984 section 71(5), incorporating by reference relevant provisions of section 70.

¹⁰ The maximum charge would have been 15%, although part would have been payable earlier. The charge could have been a great deal less, possibly nil, depending on several factors.

5 Avoidance of Charge

Depending on the trustees' powers, whether under the trust instrument or under the general law or both, it may be possible to prevent the 21% charge arising. The trustees would create interest in possession trusts in the whole of the property. This can be done even though the relevant beneficiaries are minors. Care needs to be taken in the drafting. If the beneficiaries are minors, extreme care needs to be taken.

The trustees could be given power after a decent interval to terminate the interest in possession, if they thought fit. Or it could have a limited life right from the start. Other trusts would then supervene. Normally, these would be fresh accumulation and maintenance trusts. Much, however, would depend on what was suitable from a family point of view. If the new trusts were accumulation and maintenance trusts (or interest in possession trusts), then the beneficiary whose interest had terminated would make a potentially exempt transfer. If they were not, then he would normally make a chargeable transfer. That might not matter, however, if the amounts involved were modest, i.e. less than £255,000 per beneficiary. Term insurance against payment of tax or increased tax on the beneficiary's death within seven years ought normally to be very inexpensive.

Needless to say, consideration should be given to what is possible as a matter of trust law. If the appointments are void, the charge will not have been avoided. The advice of an expert in tax and trusts is indispensable.

6 The Common Grandparent Exclusion

The common grandparent exclusion does not normally give rise to any difficulties. It has been suggested however, that it is the view of the Capital Taxes Office that in order for the exclusion to be in point, there must never ever have been any beneficiaries who were not a grandchild of the common grandparent or a qualifying child of a deceased grandchild. I shall refer to such a beneficiary as a "Qualifying Beneficiary". As I have not seen any relevant correspondence, I do not myself know whether this is the case. I shall consider the matter on principle.

First, if there has been only one period of accumulation and maintenance trusts, it is clear that the fact that there was in the past a beneficiary of those trusts who was not a Qualifying Beneficiary" is fatal, as section 71(2)(b) in terms requires

that “all the persons who are *or have been* beneficiaries” are Qualifying Beneficiaries.”¹¹

Suppose, however, that there have been two distinct periods of accumulation and maintenance trusts. Suppose, for example, that property is settled on trust for A for life and subject thereto on trust for a class of beneficiaries all of whom are Qualifying Beneficiaries. A is aged ten at the date of the settlement. During the first period of in excess of seven years, until he attains eighteen, the property will be held on accumulation and maintenance trusts and he will be the sole “beneficiary” within the meaning of section 71. Suppose he dies aged thirty and fresh accumulation and maintenance trusts come into being. Does the twenty-five year rule bite on the settled property and, if so, when?

It is clear from the wording of section 71(2)(a) that if it bites at all, it will be on the twenty-fifth anniversary of A’s death. See 4.2 above. But will it bite? In my view, it will not. For the requirement in section 71(2)(b) regarding persons who are or have been “beneficiaries” must refer to “beneficiaries” under the present accumulation and maintenance trusts. Purposive construction also leads to this result. For it is clear that in applying the twenty-five year rule in the first place one does not have regard to previous periods of accumulation and maintenance trusts (provided there have been non- accumulation and maintenance trusts in the meantime). Why, then, should one have regard to persons who are not and never were “beneficiaries” under the present accumulation and maintenance trusts? What happened previously is history.