Quilter

Managing pre 22 March 2006 Interest in Possession and Accumulation and Maintenance trusts

This information is aimed at financial advisers. By necessity the content is of a technical nature and therefore assumes a reasonable level of understanding of inheritance tax issues on the part of the reader.

This document outlines the legislation affecting pre 22 March 2006 trusts introduced in Finance Act 2006. It does not cover all scenarios but will enable you to recognise the key issues when advising on such trusts. Each trust should be considered on its own merits and tax is only one of the considerations.

The Budget 2008 has extended the transitional period from 5 April to 5 October 2008 for trustees of Interest in Possession (IIP) arrangements but not for Accumulation and Maintenance (A&M) arrangements.

Background

Finance Act 2006 introduced radical changes to the inheritance tax (IHT) treatment of IIP and A&M trusts. The effect of the new rules was to bring IIP and A&M trusts in line with the IHT regime already in place for discretionary trusts. This means that any IIP or A&M trust created on or after 22 March 2006 will be taxed under the relevant property regime (RPR) and potentially suffer the entry, 10-yearly periodic and exit charges that have always existed under the discretionary trust regime.

Unfortunately, it is not only new trusts which can be affected by this new legislation. If a change in beneficiary is made, trusts which were in existence before 22 March 2006 may also be brought into the RPR regime in future. Rather than taking effect immediately, however, the new rules introduced a transitional period which originally ran from 22 March 2006 to 6 April 2008, and with it the concept of a transitional serial interest (TSI). This period has now been extended to 5 October 2008.

During this period, the IIP beneficiary under a trust which was in existence before 22 March 2006 can be changed without immediately bringing the trust into the RPR. Additionally, under certain specific circumstances it is possible for the IIP beneficiary to be changed after 5 October 2008 without bringing the trust into the new regime.

Without the benefit of this transitional period, a change in IIP beneficiary would usually bring the trust within the new regime immediately. The consequence of this would be that the out-going beneficiary would be treated as making a chargeable lifetime transfer (CLT) – the value of which would be the then current value of the trust fund with any chargeable transfers made by that beneficiary in the preceding seven years being aggregated with it to calculate the tax. If this exceeded the then current nil-rate band (NRB) (£312,000 for 2008/09), it might result in an immediate charge to IHT at half the death rate, ie 20% of the excess over the NRB. If below the NRB there would be no immediate charge but 10-yearly periodic and exit charges might still apply in the future and might affect the amount of tax on the former beneficiary's future gifting in the next seven years.

For A&M trusts the transitional period allows some planning subject to the trust deed allowing a change to when the beneficiary becomes entitled to the trust fund. Where there is no flexibility in the trust deed, or the trustees decide not to amend the A&M trust before 6 April 2008, an existing A&M trust will be in the RPR as of 6 April 2008. See ***'future IHT treatment of existing A&M trusts'*** overleaf. The transitional period for A&M trusts was not extended in the Budget 2008.

From 6 October 2008, where an IIP beneficiary is changed by appointment or death, the future tax treatment of the trust for inheritance tax (IHT) purposes can change.

What is a transitional serial interest (TSI) and when would it be relevant?

There are three types of TSI. Each is listed below with a brief explanation. Anyone offering advice to trustees must consider whether a TSI is relevant when considering a change to the IIP beneficiary or change to the underlying investment. This document only addresses the IHT considerations.

1. **The General TSI –** pre 5 October 2008 you can only have a 'General TSI'. The conditions which need to be satisfied are as follows.

   The trust commenced before 22 March 2006 and immediately before this date there was an IIP beneficiary 'A'. For example, A's interest came to an end on or after 22 March 2006 but before 6 October 2008 and 'B' became beneficially entitled to the current interest at that time.

2. **The Spouse or Civil Partner* TSI –** only available post 5 October 2008. The conditions which need to be satisfied are as follows.

   The trust commenced before 22 March 2006 and immediately before this date there was an IIP beneficiary 'C'. For example, C's interest came to an end on or after 6 October 2008, on his/her death. Immediately before C died, 'D' was the spouse or civil partner* of C. D became beneficially entitled to the interest on C's death.

3. **The Life Policy TSI –** only available post 5 October 2008. The conditions which need to be satisfied are as follows.

   a) The trust commenced before 22 March 2006 and immediately before this date there was an IIP beneficiary 'E' and the property in the trust included rights under a life policy.

   b) The interest came to an end on or after 6 October 2008 on the death of the person beneficially entitled to it, and 'F' became beneficially entitled to the present interest,

      or

      The present interest arose on the death of the person previously entitled to it, and is an IIP that is a General TSI.

   c) The rights under the life policy in the trust are the same rights which were in the trust as at 22 March 2006 (the same life policy).

Note

In principle this means that post 5 October 2008, where a beneficiary under a pre-Budget IIP trust is changed on the death of that IIP beneficiary, and the interest is not in a pre 22 March 2006 life policy or the new IIP beneficiary is not the spouse or civil partner* of the previous IIP beneficiary, the trust will then be relevant property. If the current IIP interest is varied by the trustees post 5 October 2008, the trust will also become relevant property if there are continuing interests.

The individual circumstances of the IIP beneficiary whose interest has been given up or ended will determine whether any tax is payable now or in the future. This means a chargeable transfer on death or chargeable lifetime transfer (CLT) has been created and will be assessed against the beneficiary. The trust will be subject to a potential entry charge as well as exit and ongoing 10-yearly periodic charges associated with discretionary trusts.

Gift with reservation (GWR)

If the trustees wish to appoint benefits away from a beneficiary they will also need to consider the GWR rules.

For example, if the trustees appoint 100% benefits away from a beneficiary, that beneficiary should also be removed from being a beneficiary under the 'potential beneficiaries' class (providing the trust allows for this). Otherwise, the beneficiary would still be a potential beneficiary of the trust and the interest which has been removed (as it could be reacquired) would remain in their estate for IHT purposes. If alternatively the appointment was irrevocable this would avoid the GWR issue but an absolute appointment would have been made and any future flexibility would have been lost.

Letter of wishes

When dealing with an IIP trust one of the options available to the trustees (which would require no initial trust changes and avoid GWR and TSI issues for the time being) is for the Settlor of the trust to consider providing the trustees with a letter of wishes. Although not binding this would provide the trustees with clear guidance on the Settlor's intentions.

New money

The other major consideration is where the Settlor adds further monies (or assets purchased with it) to the trust. In principle, adding new money to a pre 22 March 2006 trust would mean the new portion of money would now be in the RPR. If the new money is added to an existing investment inside the existing trust then this will mean the whole investment will be in RPR.

However, there are special rules for pre 22 March 2006 life policies under a pre 22 March 2006 trust. For clarity, life policies include regular premium policies and single premium investment life bonds but do not include capital redemption bonds. Where regular premiums continue to be paid (or are varied under an option contained in the policy terms as at 22 March 2006) then these premiums are still treated as potentially exempt transfers (PETs) and the life policy will not be in the RPR. Where a further single premium is paid to an existing single premium life bond (under an option contained in the policy terms as at 22 March 2006) that premium is also treated as a PET and the trust will not be in the RPR.

In these circumstances, the new money must be added to the existing policies to benefit from these special provisions. All Quilter onshore and offshore bonds work this way.

Future IHT treatment of existing A&M trusts

The changes introduced for A&M trusts can be summarised as follows:

- **Absolute interest at age 18**
  The pre 22 March 2006 IHT treatment will continue as long as the beneficiaries become absolutely entitled to trust property at age 18, or the trust is varied before 6 April 2008 to provide this.
- **Absolute interest after age 18 but on or before age 25**
  However, if a pre 22 March 2006 A&M trust is varied (providing the trust allows for this) before 6 April 2008 to vest absolutely before or at the age of 25, the trust will only be subject to the RPR from the beneficiaries' 18th birthdays. In these cases the maximum charge is 4.2% (6% x 28/40) of the capital value if the entitlement is until age 25.
- **No absolute interest**
  If a pre 22 March 2006 A&M trust is not amended or does not allow for such amendment as described above, then from 6 April 2008 the trust will be subject to the RPR. The 10-yearly periodic charge will be calculated by reference to the original settlement date which means that a trust created on 1 May 1998 will suffer its first 10-yearly periodic review on 1 May 2008.

  The A&M trust can only be varied if the trust allows. If there is no provision then an application could be made to the Courts but this would have to be concluded before 6 April 2008 to enable any change to happen inside the transitional period. Consider a trust fund of £500,000 where the beneficiary is approaching 18. Appointing £500,000 to the beneficiary at 18 to avoid a maximum tax charge of 6% (which if there were a full NRB available would mean only £12,000 in tax were payable) is unlikely to be what the Settlor intended.

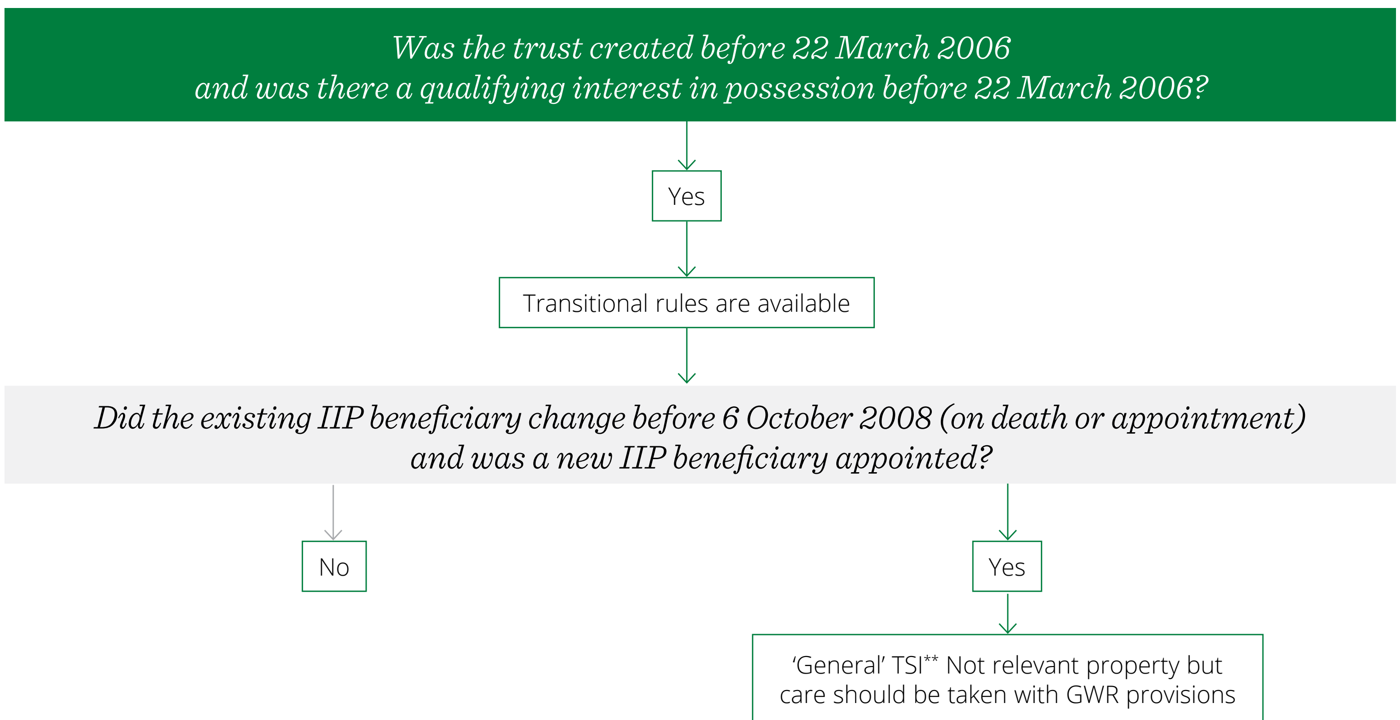
Summary

It is worth noting that tax is only one of the considerations that any financial adviser should consider when providing trustees with advice. The trustees are able to consider all the issues and personal circumstances which may well mean no action is required. Each case will need to be considered on its own merits. For example: smaller trust funds which fall below the NRB will be affected by these changes, but any variation may well avoid any immediate or future taxation consequences. However, there is a clear need for advice both during and after the transitional period.

TSI flowchart – impact on changing a beneficiary's interest in a pre 22 March 2006 Trust (IIP)

The following flowchart outlines the general principles relating to the transitional period and TSIs as introduced in Finance Act 2006. It assumes 100% of a beneficiary's interest is affected by any variation.

Post 22 March 2006 and pre 6 October 2008



Post 5 October 2008

The existing IIP beneficiary changed on or after 6 October 2008

Other than on death

Relevant property rules now apply

On death

Is the new IIP beneficiary a spouse or civil partner* of the previous IIP beneficiary?

No

Yes

Spouse/Civil Partner* TSI so not relevant property

Was the previous IIP beneficiary's interest in a pre 22 March 2006 life policy that was and has continued to be under the Trust since before 22 March 2006?

No

Relevant property rules now apply

Yes

Life policy TSI so not relevant property

* *As defined by the Civil Partnership Act 2004.*

** *On death of the new IIP beneficiary (after 6 October 2008), if the interest is in a pre 22 March 2006 life policy, the Life Policy TSI provisions can also apply.*

This document is based on Quilter's interpretation of the law and HM Revenue & Customs practice as at 1 April 2008. We believe that the interpretation is correct, but cannot guarantee it. Tax relief and the tax treatment of investment funds may change.

This communication is designed for and directed at financial advisers only. No other person should rely on the information contained within this communication.

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