MACFARLANES

TAX TREATMENT OF TRUSTS FOR INHERITANCE TAX: NEW GOVERNMENT PROPOSALS

PRIVATE CLIENT

BACKGROUND

HMRC has issued a third Consultation document entitled "Inheritance Tax: A Fairer way of calculating trust charges" on the inheritance tax regime for trusts. Two previous consultation documents have been issued. The first consultation document published in July 2012 was entitled "Inheritance Tax: Simplifying Charges on Trusts". The second consultation document was issued in May 2013 and outlined possible changes that, as well as simplifying the rules, were also aimed at preventing what HMRC considered to be an abuse of the rules by the establishment of a number of separate trusts.

This third consultation document was issued on 6 June 2014 and goes further than the two previous documents in that it sets out specific proposals for new legislation and the timing of its introduction. It broadly adopts proposals contained in the last consultation document. More importantly, however, some firm proposals have been implemented and, subject to any changes made as a result of the consultation, will apply to new trusts created and property added to existing trusts after 6 June 2014. The changes will also apply to property in existing trusts, the terms of which are changed in certain ways on or after 7 June 2014.

THE EXISTING RULES

The existing rules, which are the subject of the Consultation, relate to trusts within the "relevant property" regime. The number of trusts subject to the relevant property regime was greatly expanded by the changes introduced in 2006. Broadly speaking, all trusts are relevant property trusts for these purposes except trusts under which a beneficiary has an interest in possession (i.e. the right to the income) where that arose before 22 March 2006 and also where a beneficiary has such a right to the income in a limited number of other circumstances. When a beneficiary has such a right to the income, the trust capital is treated as owned by the beneficiary and liable to tax on their death or potentially where their interest comes to an end during their lifetime. Additionally, certain trusts for the benefit of minor children or children under the age of 25 under the will of their parent, are outside the relevant property regime.

Apart from these specific categories, assets held in trusts are subject to the relevant property regime and are liable to an inheritance tax charge on every tenth anniversary of the creation of the trust and on distributions of capital from the trust.

The existing rules, which date from 1982, contain provisions designed to limit the scope for taxpayers to reduce the rate of tax on trusts by creating a number of trusts. The way this is done under the existing rules is to add to the value of the assets in the trust, firstly, the amount of the chargeable transfers made by the settlor within seven years of making the trust and, secondly, the value of property put into another trust made on the same day as the trust concerned in working out the rate of tax.

These rules, however, did not prevent the rate of tax on trusts being significantly reduced by the creation of a number of trusts on different days. The ability of taxpayers to do this was upheld by the courts in the case of *Rysaffe*. Further, in the light of the rule that lifetime gifts are left out of account after seven years, every taxpayer can effectively make a new trust every seven years each with the benefit of a full nil-rate band. It is primarily this aspect of the existing rules which the new proposals are designed to restrict, as well as tightening up the rules in other ways. The proposals are also designed to simplify the way in which the tax charges are calculated.

THE NEW PROPOSALS

The proposals contained in the Consultation document (which although subject to consultation are unlikely to be significantly changed) are as follows.

The settlor making a trust or trusts will have a separate nil-rate band (currently £325,000) which can be allocated between all the trusts made by that settlor on or after 7 June 2014.

The settlor will be able to elect how much of the nil-rate band in percentage terms should be allocated to each trust that he or she makes. Any increase or decrease in the nil-rate band would therefore feed through to the trust. The election will have to be made by the settlor to HMRC and the settlor will have the responsibility of providing a copy to the trustees showing the amount of the nil-rate band allocated to the trust so that the trustees can accurately calculate the inheritance tax due on the 10-year charges and the charges on capital distributed from the trust. This is designed to give the trustees certainty and addresses the point made in response to the second consultation that trustees would not know how to calculate the inheritance tax on the trust concerned because they might not necessarily know how many other trusts the settlor had made or might make in the future.

Trustees will need to be able to provide evidence to HMRC of the amount of the nil-rate band allocated to them. Keeping a copy of the election would meet this requirement.

If no election is made to allocate part of the nil-rate band to the trust, the trustees would have to calculate the charge on the basis that none of the nil-rate band was available.

The date on which the election is made will be flexible. The consultation document states that an election can be made when a new settlement is made or at any time up to the payment of the first charge to inheritance tax. It is, however, envisaged that most settlors are likely to make the election and the allocation of the nil-rate band when the trust is set up.

The allocation of the nil-rate band to a settlement can be amended or withdrawn until the point of the due date for the payment for the first charge to tax. Importantly, however, once an allocation of the nil-rate band has been used in the calculation of an inheritance tax charge, the allocation of the nil-rate band to that trust cannot be reduced; it can, however, be increased for future charges to the extent that any part of the nil-rate band remains unallocated to any other trust.

If the settlor should die, the executors or administrators of the settlor's estate would have two years to make an election to allocate the nil-rate band to settlements created by the will to make sure that the deceased's nil-rate band had been fully allocated between the settlements made during lifetime or on death.

Where property is added to a trust made before 7 June 2014 the settlor will be able to allocate any part of the available nil-rate band to the added property. The property put into the trust before 7 June 2014 would remain subject to the existing rules.

If HMRC later discover that too much of the nil-rate band has been claimed by the executors, the claim will be reduced on the chronological order of the elections that have been made.

Where a trust is fully wound up (or paid to charity) the allocation of the nil-rate band to that trust will become available again. The settlor will be able to reallocate that part of the nil-rate band to other settlements they have made. Note, however, that where the settlor has died and the trustees wind up a trust, the nil-rate band allocated to that trust cannot be reallocated to another trust created by the same settlor. The result will be that the nil-rate band allocated to the trust that is wound up is lost as the settlor has died. This point would need to be borne in mind on trust rearrangements following the death of the settlor.

THE SETTLOR'S PERSONAL NIL RATE BAND

While the Consultation document is not entirely clear, it is understood that a settlor's own personal nil rate band will not be affected by the new proposals.

It follows that a settlor will, as previously, be able to make a new trust within their nil rate band every seven years without a charge to inheritance tax.

RATES OF TAX

The rates of tax under the current rules often have the result that the rate is significantly reduced from the maximum rate of 6 per cent to a somewhat lower rate. This is often due to the fact that the property has not been in the trust for a full 10 year period or has not been relevant property (for example because a beneficiary has had a qualifying right to the income) for some part of that period. Under the new proposals this will not now always be the case and a flat 6 per cent rate will apply in some cases. So although the calculations will be simplified the rate of tax will increase. Unlike the new rules for the allocation of one nil-rate band between trusts made after 6 June 2014 the new method of calculating the rates of tax will it seems apply to all trusts whenever made.

TIMING

The rules will come into effect mainly on 6 April 2015. However, in order to prevent settlors making a number of trusts in advance of that date to take advantage of the existing rules and the ruling in the *Rysaffe* case, the new rules will apply to trusts made after 6 June 2014. Specifically, the rules will apply to:

- new trusts made after 6 June 2014;
- additions of property or funds to existing trusts made after 6 June 2014; and
- existing trusts where changes are made after 6 June 2014 which result in property becoming "relevant property" (for example, where a beneficiary's right to the income created before 22 March 2006 is brought to an end).

However any tax charges arising before 6 April 2015 in respect of settlements or additions made after 6 June 2014 will be calculated in accordance with the current rules.

THE IMPLICATIONS OF THE NEW RULES

The new proposals will complicate arrangements for taxpayers setting up new trusts. For example, where a new trust is made the settlor may not know how many future trusts he or she will wish to make and will have the difficult choice of either allocating the whole of the nil-rate band to the first trust (thereby limiting the ability to allocate any part to future trusts) or alternatively, the settlor would need to allocate only part to the new trust and effectively waste part of that nil-rate band pending the creation of further trusts. This is the consequence of the allocation of a nil-rate band not being able to be reduced where the first charge to tax has arisen in relation to a settlement.

Care should be taken on structuring and additions of property to existing trusts. While it appears that only the assets added to an existing trust after 6 June 2014 will be within the new rules (the pre-existing assets will not be affected and will be subject to the existing rules), complications may well arise in ascertaining which assets in the trust represent additions after 6 June 2014. Likewise, where there are trusts which are currently not relevant property trusts, any rearrangement of the trust with the effect of causing the trust assets to become relevant property (for example, the bringing to an end of a beneficiary's income interest) will require careful thought.

THE WAY FORWARD

The consultation period ends on 29 August 2014. We will comment further when the consultation process has finished and when further or altered proposals are published, or the ways in which the new provisions may be implemented are known.

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