NEW INHERITANCE TAX RULES

The chancellor, Gordon Brown has revised his proposed Budget measures in respect of trusts, following protests by the life assurance industry and MPs amongst others.

HMRC have published additional guidance with the draft Finance Bill, which states that there will be no 'retrospective tax charges' to trusts. What the guidance fails to explain is that there will be new charges to certain existing trusts if the terms of the trust are not changed.

All future as well as existing bare trusts are not affected by the changes. An example of a bare trust would be a life insurance policy set up to pay off a mortgage if a person dies, and this remains outside the new rules.

The Finance Bill sets out the details of how the rules for Accumulation and Maintenance (A&M) Trusts and Interest in Possession (IIP) Trusts announced in the Budget, will be applied. Lifetime transfers into accumulation and maintenance trusts or interest in possession trusts have always been exempt from inheritance tax (IHT) if the settlor lived for the next seven years. These trusts have also not been subject to the periodic or exit charges suffered by other trusts.

Legislation has been proposed to make these types of trust immediately chargeable to IHT.

The new rules will apply from 22 March 2006 to new trusts and to additions of new assets to existing trusts. There are transitional provisions which will apply to existing trusts in the period up to 6 April 2008.

The new rules will apply the provisions currently relating to discretionary trusts to both A&M and IIP trusts. So there will be:

- a chargeable transfer on entry with a lifetime rate of 20%;
- a periodic charge of up to 6% every ten years; and
- an exit charge when funds leave the trust between periodic charges.

There will be some limited exceptions to the new rules.

Existing A&M trusts which provide that the assets in trust will go to a beneficiary absolutely at 18 – or where the terms on which they are held are modified before 6 April 2008 to provide this – the current IHT treatment will continue.

Where the entitlement rules are different, the trust assets will become 'relevant property' from 6 April 2008 and the periodic and exit charges will apply.

The current rules for existing IIP trusts will run on until the interest in the trust property at 22 March 2006 comes to an end. Any subsequent trust will broadly fall to be assessed to the periodic and exit charges.

Where a trust is set up by a will, then the trustees will have two years to alter the terms of the trust to comply with the new rules. In this period any changes they make will be treated as if made in the will itself.

See following pages for GUIDANCE NOTES and Q & A SECTION

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HMRC GUIDANCE NOTE

CLAUSE 157 and SCHEDULE 20 – RULES FOR TRUSTS

The Finance Bill, published today, sets out the details of how the rules for Accumulation and Maintenance Trusts and Interest in Possession Trusts, announced in the Budget, will be applied.

The Finance Bill makes absolutely clear that there is no retrospective tax charge. In particular, no one who wrote a life insurance policy into trust before Budget Day will have to pay an inheritance tax charge. All of these continue to be exempt from inheritance tax as they were before the Budget. This means that statements about millions of people being affected by the change remain simply incorrect.

The Finance Bill and its Explanatory Notes provide complete certainty that the new rules will not apply to life insurance policies entered into before Budget Day, even where the policy holder continues to make payments after the Budget under the original terms of the policy.

The Finance Bill also makes clear that all future as well as existing bare trusts are not affected at all by the changes. This ensures straightforward life insurance policies, which, for example, are set up to pay off a mortgage if a person dies, are outside the rules.

No one who takes out a new insurance policy designed to provide security for their families if they die will be affected where there is either no value in the trust to tax – the vast majority – or the value is below the £285,000 threshold. If the policy does eventually acquire value above the threshold, which rises to £325,000 by 2009, then the maximum inheritance charge is 6% after 10 years on the excess amount.

No new insurance product that has an investment element is affected unless value is accumulated over £285,000 in a seven year period – that is equivalent to savings of £40,000 a year or a single payment of more than £285,000. And, again, inheritance tax is only paid on the excess amount above the threshold.

Taken together, as the Government has repeatedly made clear, these factors mean that the Government’s estimate of the amount this measure will raise is only £15 million a year in revenues and will affect only a very small number of very wealthy people.

The Finance Bill and its Explanatory Notes makes clear that the existing spouse exemption and other reliefs from inheritance tax will continue to apply where a trust is set up in the case of an individual with dependants dying intestate. And where a trust is set up by a will, then the trustees will have 2 years, if needed, to alter the terms of the trust to comply with the new rules.

RULES FOR TRUSTS – Q&A

I've read that millions of people will have to pay more IHT as a result of this change – will this apply to me?

- There is no retrospective tax charge.
- Life insurance policies written into trust before Budget day will not have to pay more IHT as a result of this change
- Bare trusts are not affected by the changes.
- Trusts that fall under the new rules because they were set up on or after 22 March 2006 (Budget day) will only have to pay IHT on amounts in excess of the threshold of £285,000, rising to £325,000 by 2009.

Are these tax changes retrospective?

- No – the new rules apply only to new trusts set up on or after Budget day, and to post Budget day settlements on existing trusts.
- There are transitional provisions for existing trusts. This means they have 2 years to reorder their affairs, if necessary, to ensure they continue to benefit from their pre-Budget treatment. And life insurance policies written into trust before Budget day will not have to pay more IHT as a result of this change.

Will existing life insurance policies written into trusts have to pay more IHT as a result of these changes?

- No - life insurance policies written into trust before Budget day will not have to pay more IHT.
- Policies written into "bare" trusts are not affected by the changes.
- Policies written into "flexible" trusts before Budget day will continue to benefit from their pre-Budget treatment. This includes regular premium policies where payments continue after Budget day.

I put a single premium life policy into a "flexible" trust before Budget day – is my policy affected by the new rules?

- No – your trust will continue to benefit from its pre-Budget treatment.

I am putting money into a life insurance endowment policy held in trust so my premiums build up value. Will that be affected?

- Existing policies will not be affected by the new rules provided you do not increase the premiums you pay or extend the term of the policy after the Budget.

I am continuing to pay regular premiums on a life insurance policy written into a “flexible” trust before Budget day – is my policy affected by the new rules?

- No – your trust will continue to benefit from its pre-Budget treatment, provided you do not increase the premiums you pay or extend the term of the policy after the Budget.

Will new life insurance policies written into “bare” trusts be affected?

- No – the new rules do not affect the position of bare trusts.

Will new life insurance policies written into “flexible” trusts be affected?

- Policies written into flexible trusts on or after Budget day will only be affected if their value exceeds the IHT threshold of £285,000, rising to £325,000 by 2009.
- IHT charges will only apply to the excess above this threshold.

Will existing A&M trusts have to pay more IHT as a result of these changes?

- No more IHT will be due if the assets in trust are less than the threshold of £285,000, rising to £325,000 by 2009.
- For the small number of existing trusts with assets over £285,000, there will be no IHT to pay so long as the trust provides, or is amended during the transitional period to provide, that the beneficiary or beneficiaries will become entitled to the assets at 18.

Why has the Government chosen age 18 rather than 25?

- The Government has simplified the rules for IHT to align them with those already in place for income tax and capital gains tax. The relevant age is now 18 across the piece.
- This age was part of the public consultation on modernising the tax system for trusts. The result of that consultation was that special rules for children should cease when a child reaches adulthood at age 18.

I have a will that sets up an A&M trust under which my child will not become entitled to the assets until age 25. Do I have to rewrite my will?

- Trusts set up after Budget day will only have to pay IHT on amounts in excess of the threshold of £285,000, rising to £325,000 by 2009.
- If someone dies before they have amended their will, then it is possible to change an inheritance within 2 years by a ‘variation’. This is treated for IHT purposes as though it was done by the will.

If trustees amend an existing trust set up by a will to bring it into line with the new rules, will this enable the trust to benefit from the provision for trusts set up on death?

- Yes – actions taken by the trustees will be treated for IHT purposes as actions taken in the will itself, so long as such actions occur within 2 years of death.

Is spouse exemption withdrawn for cases where a person dies intestate?

- No – the current treatment for trusts created on intestacy will continue.

As part of the wider modernisation of trusts, the Finance Bill reduces the age limit at which children should become entitled to the assets of a trust from 25 to 18. This simplification measure aligns the age limit for inheritance tax with those for income tax and capital gains tax. This age limit was part of the public consultation on modernising the tax system for trusts launched in the 2003 Pre-Budget Report. The result of that consultation was that special rules for children should cease when a child reaches adulthood at the age of 18.