

The Finance Act 2006 – Do you need to change your Will?



HEWITSONS

Introduction

You should regularly review your Will and ensure it is up-to-date, bearing in mind any changes in your financial and family circumstances as well as the current tax rules.

The Finance Act 2006 changes to the Inheritance Tax rules penalise gifts into Trusts and the retention of assets in Trusts in certain circumstances, but they will not bring to an end the widespread use of Trusts for financial, family or indeed tax planning reasons – particularly in the context of Wills where the timing of the transfer of assets cannot be foreseen.

While it may be feared that the tax rates will increase in the future, payment of the maximum tax rate of 6% every 10 years may prove worthwhile where the alternative is the loss of the assets through inheritance at an early age or a charge on death at the death rate of 40%.

Please note that a gift to children or grandchildren at a specified age will automatically give rise to a Trust, unless it is provided to the contrary.

The New Rules

Under the **relevant property tax regime** which has applied to Discretionary Trusts for many years, Inheritance Tax is payable currently at a maximum of 6% on each 10 year anniversary of the commencement of the Trust and on capital distributions. The Nil Rate Band (which is now £312,000) and Agricultural and Business Property Relief can reduce the tax liability.

For deaths on or after Budget Day on 22nd March 2006 the **relevant property regime** will apply to all except certain favoured Trusts. In particular the favoured status afforded to Accumulation and Maintenance Trusts, where children become entitled to the income from the trust fund (but not necessarily the capital) by the age of 25, will no longer apply.

In most cases of Trusts created under Wills, tax is payable under the **relevant property regime** where the trust fund exceeds the Nil Rate Band (after taking into account any Agricultural or Business Property Relief). Therefore the changes are only of concern where the trust fund is likely to exceed the Nil Rate Band after any such Reliefs. Moreover the availability of Capital Gains Tax holdover relief can be advantageous.

Trusts enjoying favoured status are:

Bereaved Minor Trusts

To qualify the Trust must be set up by parents, step-parents or others with parental responsibility under a Will or intestacy rules. A grandparent can only establish **BMT** if they have parental responsibility.

The child must be entitled to the capital at the age of 18.

Assets in a **BMT** will not be subject to the **relevant property regime** and there will be no Inheritance Tax liability on the death of the child under the age of 18 or on the distribution of capital to the child. Capital Gains Tax holdover relief will be available on capital distributions.

Age 18 to 25 Trusts

This is a Trust where a child will become entitled to the capital by the age of 25 and is otherwise in the form of a **BMT** i.e. it can only be established by a parent on death. In the case of an **18 to 25 Trust** Inheritance Tax is potentially payable on a capital distribution to the child but only if this takes place after the child has reached 18 and the maximum rate of tax is currently 4.2%.

Immediate Post-Death Interests

An **IPDI** arises where property is left by Will or intestacy on trust to pay income to a person ('the Life Tenant') for life or any shorter period e.g. until reaching the age of 25. The right to income, known as an interest in possession, must arise immediately on death.

The trust fund is not subject to the **relevant property regime** and will be taxed under the pre 22 March 2006 rules so that the assets are taxable on the death of the life tenant.

Therefore where the surviving spouse/civil partner has an interest in possession the Inheritance Tax spouse exemption should apply.

How will they affect different Wills?

Gift of the Nil Rate Band to a Discretionary Trust with the residue of the estate passing to the spouse outright, failing which to the children equally at 25.

The FA06 changes have not altered the tax treatment of the gift of the Nil Rate Band to a **Discretionary Trust** on the death of the first to die of married couple/civil partners. The Nil Rate Band was increased to £312,000 on 6 April 2008.

The Will may also include Further Nil Rate Sum provisions which give the Executors the ability to use the 'loan scheme' following the first death with a view to Inheritance Tax efficiency where an interest in the matrimonial home is to be used towards the Nil Rate Band gift. While the FA06 changes may mean that in future it will no longer be necessary to use the loan scheme, the Revenue's approach is not yet clear. Therefore the Further Nil Rate Sum provisions may still be useful.

Where assets are retained in trust until a child is 25 there will be a potential Inheritance Tax charge on capital distributions of up to 4.2% at current rates. If the qualifying age is 21 the maximum tax rate currently is 1.8%.

However this will generally only apply if the trust fund exceeds the Nil Rate Band. Also the position can be reviewed after the death and before the child is 18, as, if the trusts are changed before the child is 18 to give him capital at 18, the potential Inheritance Tax charge is avoided. Moreover, the availability of Capital Gains Tax holdover relief can be advantageous.

If the trust fund is likely to exceed the Nil Rate Band and your intention is to retain assets in trust beyond the child reaching the age of 18, then consideration should be given to the use of an IPDI or a **Discretionary Trust**.

Gift of the residue of the estate to an Interest in Possession Trust for the surviving spouse, rather than to the spouse outright.

The changes initially announced in the 2006 Budget would have denied the availability of the Inheritance Tax spouse exemption in these circumstances because of the Trustees' powers to alter the trusts and the provisions applying on the subsequent death of the surviving spouse.

Before the FA06 was passed the Government withdrew this change so that the Inheritance Tax spouse exemption does apply, even where the Trustees have the power to override the interest of the surviving spouse and to change the trusts to benefit the surviving spouse and children.

However the FA06 extended the gift with reservation of benefit rules so that any termination of the spouse's interest will now be treated as a gift for these purposes. Therefore, these arrangements can no longer be used to divert assets after the first death to a **Discretionary Trust** where the surviving spouse and children are beneficiaries, using the Nil Rate Band of the surviving spouse but without the assets of that Discretionary Trust being taxable on the death of the surviving spouse.

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Gifts to Grandchildren

A grandparent cannot establish a Bereaved Minor Trust and so any Trust for grandchildren will be potentially taxable under the **relevant property regime** if the assets exceed the Nil Rate Band.

Therefore if the assets are likely to exceed the Nil Rate Band, consideration should be given to the use of an **IPDI**. This would provide for the grandchild to have the right to receive the income of the Trust from the death of the testator. Although the 10 year and exit charges will not apply, the trust fund will be taxable on the death of the grandchild and also there may be Capital Gains Tax payable on the distribution of capital to the grandchild. Alternatively a **Discretionary Trust** may be preferable.

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