IHT planning through life policy trusts

Synopsis: A summary of the main impact of FA 2006 changes on new and existing life policy trusts.

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In what follows examines the inheritance tax (IHT) position of the main types of “life policy trusts” in use addressing both post-2006 Budget and pre-2006 Budget trusts. By “pre-2006 Budget” we mean trusts executed before midnight on 21 March 2006.

Flexible interest in possession trusts

Post-2006 Budget trusts

Transfers into trust...

- Regular premiums - if the appropriate relevant conditions are satisfied, regular premiums should continue to be exempt under the normal expenditure out of income and/ or annual exemption. If the transfer is not exempt it will be a chargeable lifetime transfer (CLT). If the transfer is large enough, it may need to be reported and the trust registered (please see below).

Transfer of existing policies/investment bonds – these will be CLTs...

- If the value of the transfer (after available annual exemption(s) but including any CLTs made in the previous seven years) is below the nil rate band - no immediate tax consequences will arise but there will be a requirement for reporting the transfer on form IHT 100a if it causes total chargeable transfers in a seven-year period to exceed the nil rate band (for transfers of cash or listed shares/ securities) or 80% of the nil rate band for any other assets.

- If the value of the transfer causes the nil rate band (including any chargeable transfers made in the previous seven years) to be exceeded – an immediate tax charge at 20% on the excess is payable. If the settlor is going to pay the IHT, grossing up will be required to calculate the IHT bill. Broadly speaking, the settlor’s liability, where he or she pays the tax, will be 25% of the amount transferred in excess of the nil rate band (as the tax paid by the settlor on behalf of the trustees is treated as a further gift into the trust).

Exit charges can arise when property leaves the settlement, for example, when capital payments are made out of the trust to the beneficiaries. An obvious example would be payment of the policy proceeds (after the sum assured has been paid to the trustees by the life company) to the beneficiaries. The exit charge would often be nil if a payment were made within the first ten years, provided the value of the trust property (the policy) immediately after the trust was created together with

the cumulative total of the settlor's chargeable transfers in the seven years prior to the gift plus any added property is below the nil rate band at the time of the exit.

If premiums under a life policy in trust are paid direct to the life company those will not be added property. The amount of an exit charge after a ten-year anniversary will depend on the rate of the last periodic charge, if any (please see below). Thus, if there is no periodic charge, there will be no exit charge in the following ten years. If there was a periodic charge, then the exit charge will be such fraction of the previous periodic charge as results where the numerator is the number of complete periods of three months (quarters) since the last periodic charge and the denominator is 40. So, for example, six years (24 quarters) after a periodic charge, the fraction would be (24/40ths).

Periodic charges - the periodic charge is applied to the value of the settled property, i.e. the policy, at the time of the charge. The basis of valuation is the open market value and this would usually be the surrender value. However, under a protection plan, if the life assured were in serious ill-health then the value of the policy for IHT may well be more than the surrender value. For non-term policies, it may be necessary to take into account the premiums paid in the valuation for the purposes of the periodic charge. This is an issue over which there is still some uncertainty. HMRC has confirmed to the ABI that it did not expect individuals to have medicals every ten years for the purposes of the new legislation. Therefore, provided the individual is not seriously ill to the best of their knowledge and belief, no further action would be needed.

So...

For most single premium bonds in flexible trusts, if the value of the policy at the time of the periodic charge and the settlor's cumulative total of transfer in the seven years leading up to the creation of the trust is below the nil rate band, no periodic charge should arise.

For protection plans with low/ no surrender value then, unless...

- the settlor is in serious ill-health at the time of a periodic charge; or...
- the sum assured had been paid, exceeds the then nil rate band and is held in trust at the ten-year anniversary; or (possibly).
- the premiums paid under non-term assurances (whole of life policies, for example) are significant so that the value for IHT at the time of the periodic charge is greater than the then nil rate band (taking account of the cumulative total of chargeable transfers made in the seven years immediately preceding the commencement of the settlement)...

There should be no periodic and no exit charges under the discretionary trust regime.

Where there is the perceived risk of a charge then...

- Settlors should consider the use of a bare trust where they are absolutely happy that they will not wish to change the beneficiaries; and, if a bare trust is not appropriate…

- Securing the cover they need through a series of "sub nil rate band" smaller policies (e.g. £1,000,000 of cover as five separate policies of £200,000) each subject to a separate trust created on different days. Under current law (following the Rysaffe decision), in most cases, each would effectively be entitled to its own nil rate band and should not give rise to any periodic charge in the future, provided the settlements do not become related settlements.

As a result of discretionary trust treatment applying to flexible interest in possession (IIP) trusts, it is likely that many new trusts, where flexibility is required, will be established on a fully discretionary (non-IIP) basis.

Pre-2006 Budget trusts

If both the policy and the trust came into effect before 22 March 2006 and premiums continue to be paid on or after that date, the policy value qualifies for transitional protection as an asset of a pre-Budget settlement. This means that it will continue to be subject to IHT in the same way as it was before 22 March 2006. This will also apply…

i. if, say, the premiums are increased on or after 22 March 2006, provided the original terms of the policy provide for this variation (an allowed variation); and…

ii. will continue to apply where somebody later becomes entitled to an IIP under a pre-2006 Budget policy on the death of a previous owner of the IIP.

This means that…

(1) Premiums paid into a policy effected in trust before 22 March 2006 will not cause the policy to be 'tainted' (subject to the new IHT trust provisions that apply to post-2006 Budget policy trusts).

(2) Premiums paid on or after 22 March 2006 to these trusts will continue to be treated as potentially exemption transfers (PETs) and will not be CLTs.

(3) A policy can be enhanced (e.g. by increasing the premiums) after 21 March 2006 without causing the policy to be subject to the new IHT provisions if the original policy terms provide for such an enhancement or give the policyholder a right to effect it. This means that, in those circumstances, the benefits can be increased or the term of the policy extended, without changing the IHT treatment of the policy.

(4) If a beneficiary becomes entitled to an IIP following the death of the previous holder of the IIP, this will not cause the policy to be subject to the new rules provided the previous holder of the interest…

- held that interest immediately before 22 March 2006; or…

- held that interest as a transitional serial interest (so that it had been made via an appointment to him or her before 6 October 2008 – please see below). It must be noted that this exclusion only applies if the "succeeding" IIP was acquired on the death of the beneficiary with the prior IIP. "Transitional serial protection" would not be secured if the new IIP were secured as a result of the exercise of a power of appointment during the beneficiary's lifetime.

The generally applicable transitional serial interest provisions applying when an IIP comes to an end and a new IIP arises before 6 October 2008, however the appointment is made, will also apply. An IIP arising as a result of such a pre-6 October 2008 appointment will be treated as one that was in place before 22 March 2006. This means that the settlor/trustees had until 5 October 2008 to make appropriate appointments without bringing the trust into charge under the new provisions. It should be noted that such an appointment before 6 October 2008 could be made only once for a particular interest in the trust.

If a new IIP is created otherwise than on death of a beneficiary, (e.g. on a change of default beneficiary with the flexible power of appointment continuing), the trust will be treated as a discretionary trust from then on (to the extent of that interest) and a CLT would arise if the amount was not exempt. This applies even if the newly named beneficiary is the spouse/civil partner of the previously named beneficiary, i.e. the spouse/civil partner exemption will not apply. For the purposes of the periodic charges, the trust will be treated as commencing at the date the original trust was established.

As explained above, any appointment of benefits to a new interest in possession beneficiary that was made before 6 October 2008 would have resulted in a transitional serial interest and so would not have brought the trust into the IHT discretionary trust regime.

It must also be noted that, under the Finance Act 2006, a gift with reservation occurs when an IIP terminates and the trust continues with the "disappointed" beneficiary remaining a potential beneficiary. This means that…

a. If the IIP terminates after 5 October 2008, the termination gives rise to a CLT, that part of the trust is within the IHT discretionary trust regime for the future and the value of the policy (or at least the value of the interest given up) will be in the "disappointed" beneficiary's estate as a gift with reservation of benefit. This can give rise to a potential double tax charge on the death of the "disappointed" beneficiary within seven years of the appointment, however, the double charges relief regulations should provide relief for the potential double charge. These will not help though in respect of the periodic or exit charge as no double charge arises.

b. If the IIP terminated before 6 October 2008 and the trust continues so as to take advantage of the transitional rules, there will be a PET by the

"disappointed" beneficiary. If the "disappointed" beneficiary remains a potential beneficiary, the termination will however still be treated as a gift with reservation of benefit. If the new IIP ends after 5 October 2008 and the trust continues with the "disappointed" beneficiary remaining a potential beneficiary, the position in (a) will apply.

Action

- No additional transfers/gifts should be made to existing trusts – apart from the continuing payment of regular premiums in accordance with the terms of the contract or in connection with an allowed variation.

- Changes to the default beneficiaries should be avoided.

Accumulation and maintenance (A&M) trusts

These are not common with life policies but are more commonly used with investments such as OEICs.

Post-2006 Budget trusts

There is no IHT advantage in drafting new trusts (i.e. after 21 March 2006) in the "old" A&M style.

The pre-Budget 2006 provisions dealing with A&M trusts (section 71 IHTA 1984) do not apply to any settlements created after 21 March 2006. For lifetime trusts for the benefit of children or grandchildren (other than absolute trusts), the IHT treatment is now the same, i.e. as for post-2006 Budget flexible trusts and discretionary trusts – please see above. There are, however, special provisions for trusts created in a will for minor children of the deceased, please see below.

Pre-2006 Budget trusts

Pre-Budget 2006 A&M trusts will be caught by the new provisions unless they provide (or were amended before 6 April 2008 to provide) that the beneficiary becomes absolutely entitled at age 18. After some considerable pressure to extend this to age 25, the Government made some concessions by introducing new "age 18-to-25 trust" provisions to apply to certain Will trusts (please see below) and extended this to pre-2006 Budget A&M trusts where the settlor has died and the trust was amended to meet the relevant conditions.

- Action taken will depend on the size of the fund - the value of the vast majority of these trusts will be below the nil rate band and therefore will not be a problem.

- If the settlor was still alive and fund was in excess of the nil rate band, or the settlor had exceeded his/her nil rate band at the time he/she made the settlement, the trustees will have had to consider whether to change the terms of the trust to grant the beneficiary an absolute right at age 18

(assuming this was possible under the trust). This will have been a question of weighing the loss of flexibility against the likely IHT charge.

- Where the settlor had died, the trustees had to consider amending the trust (assuming this was possible) to meet the "age 18-to-25 trust" conditions. They had until 6 April 2008 to do so. If they did so, then the trust will not enter the new IHT regime until the beneficiaries attain age 18. The IHT charge on the beneficiary becoming absolutely entitled will then depend on when this happens, with a maximum charge of 4.2% if the entitlement is at age 25. In many cases, the rate actually charged will be lower than this.

Action

For arrangements established on or after 22 March 2006, given that section 71 no longer applies to grant favoured tax treatment if the relevant conditions are satisfied, it is likely that there will be little incentive to create trusts for children or grandchildren with such complex beneficial clauses where a simple discretionary trust would achieve the same tax treatment and offer greater flexibility.

Points arising from trust taxation reform (capital gains tax (CGT)/ income tax)

If the settlor's minor unmarried child, who is not in a civil partnership, is a beneficiary, this would have become a settlor-interested trust for CGT purposes under the revised definition of settlor-interested trust contained in s77 TCGA 1992. This provision was effective from 6 April 2006 and meant that all trust gains would be assessed on the settlor. It should be noted that this is a wider provision than the income tax anti-avoidance provision where trust income will only be assessed on the parental settlor if the child is either entitled to the income or the income is actually paid to the child (e.g. from an A&M trust). This was therefore an unwelcome complication for A&M settlements for children.

However, when a single rate of CGT was introduced in 2008, there was no longer a need for such anti-avoidance legislation which led to the repeal of s77 TCGA 1992 with the result that the trustees are now assessed and this still remains the case.

Loan trusts

Prior to Budget 2006, these trusts were mostly based on flexible power of appointment (POA) trusts. Since 22 March 2006, most arrangements use discretionary trusts and therefore most of the above (for both pre- and post-2006 Budget trusts) will apply.

Where the loan trust is based on an absolute/ bare trust, the discretionary trust provisions are not relevant. For larger cases, it may be that greater interest is shown in bare trusts to the extent that the lender is happy to make a loan to trust on the basis that no changes to the trust beneficiaries can be made once the trust has been established. Combinations of flexible (POA)/discretionary trusts and bare trusts are possible too for the larger cases. It may be that the arrangement is set up

on a flexible/discretionary basis up to a level where the nil rate band is unlikely to be exceeded and on a "bare" basis for any balance. An alternative is, of course, to set up separate loan trusts on separate days. Each should then have its own nil rate band, and the making of each loan is not a transfer of value and hence does not add to the cumulative total of chargeable transfers.

Where arrangements are based only on a loan, i.e. there is no initial gift, there will be no possibility of a chargeable transfer on setting up the trust. Even where the structure is commenced with an initial gift, this is likely to be exempt.

For a loan trust subject to the discretionary trust provisions, the value of the settled property for the purposes of the periodic charge is the value of the property less the amount of the outstanding loan. Loan repayments will not trigger exit charges.

If there is thought to be a danger that a periodic charge could arise, consideration should be given to effecting a series of smaller loan-only trusts (or gift and loan trusts under which the gift is exempt), each effected on different days. Under the "Rysaffe" rule, each trust would be treated separately and, assuming the transferor had made no previous CLT, would have its own nil rate band, provided that the trusts did not subsequently become related settlements.

For pre-2006 Budget loan trusts on a flexible POA trust basis, the discretionary trust rules will not apply unless the trust is amended so as to trigger the new charge. For post-2006 Budget trusts, then unless the sum of the trust value (less the outstanding loan) and the cumulative total of transfers made by the settlor in the seven years preceding the creation of the trust exceeds the nil rate band, no IHT charge should arise. Please see above for a strategy to minimise the possibility of a periodic charge by effecting a series of smaller loan trusts on separate days each with its own nil rate band.

Retained interest trust

The gifted part of this trust will present the same potential problems as under a flexible trust (please see above).

Discounted gift trusts

Post-2006 Budget arrangements

- The gift element of the investment will be a chargeable transfer for IHT. This will be based on the discounted value. It will be necessary to inform HMRC on forms IHT100 and IHT100a where the settlor's cumulative total of CLTs exceeds 80% of the nil rate band (i.e. exceeds £260,000). Note that for gifts of cash and listed shares/securities, the figure is 100% of the nil rate band.
- For the purposes of the periodic charge, what is relevant is the value of the relevant property in the settlement immediately before the ten-year anniversary. HMRC has confirmed that the value of the relevant property in a discounted gift trust (DGT) is the value of the funds held (i.e. the single premium bond) less the value of the settlor's reserved rights at that time. In addition, HMRC commented that while, strictly speaking, the settlor's rights

would need to be revalued every ten years, which would require fresh underwriting, in practice it would be acceptable to add ten years to the settlor's age at each ten-year anniversary, provided the DGT was underwritten at outset and the trustees were not aware that the settlor's health had deteriorated.

- The value of the relevant property, as outlined above, will be potentially subject to the periodic charge (the ten-yearly charge), i.e. maximum 6%, although usually will be less or even nil. The same considerations as for flexible trusts will apply in determining if, and to what extent, charges apply.

- Exit charges can arise when amounts cease to be relevant property, e.g. when sums leave the trust. HMRC has however confirmed that the capital payments paid to the settlor do not give rise to exit charges. Of course, payments to other beneficiaries (usually after the settlor's death) would be subject to exit charges in the usual way.

Action

For those who are certain who they wish to benefit and do not wish to change their mind, a bare trust may be appropriate.

Properly drafted, it should also be possible to prevent the trustees being compelled by the beneficiaries to wind the trust up.

If a trust other than a bare trust is to be used, clearly, it would not be advisable to effect a DGT where the discounted gift plus other chargeable transfers made by the settlor in the previous seven years exceeded the nil rate band, if it is desired to avoid an immediate lifetime IHT charge.

With the benefit of advice, in larger cases, a combination of flexible POA/discretionary trusts and bare trusts may be appropriate.

Given that the discretionary trust rules now apply to all but bare trusts, most post-2006 Budget DGTs tend to be set up on a fully discretionary basis.

Pre-2006 Budget trusts

The IHT treatment will continue based on the pre-2006 rules as long as there is no change in the person entitled to the IIP, or such a change occurs only following the death of the beneficiary previously entitled to an IIP, and no property is added to the settlement. Furthermore, any change in the interest in possession entitlement that was made before 6 October 2008 gave rise to a transitional serial interest. Please see above.

Probate trusts and "lifetime" self-settlements

These are trusts under which the settlor is entitled to a life interest with the power of appointment vested in the trustees.

Post-2006 Budget trusts

Any trust of this type created on or after 22 March 2006 will be treated as a discretionary trust for IHT purposes, whilst the value of the trust fund would also be in the estate of the settlor as a gift with reservation of benefit (this assumes that the trustees have the power to appoint capital to the settlor).

Of course, there would be some relief from the double charge in respect of the initial transfer and the reservation of benefit on the death of the settlor within seven years of making the transfer under the Inheritance Tax Act (Double Charges Relief) Regulations 1987. There would, however, be no relief in respect of any periodic or exit charges, as there would be no double tax charge at that time.

In addition, any gift with reservation problem could be avoided if the settlor's right was a proper carve-out. However, this would probably not be acceptable to settlors of such trusts and would not fit well with the underlying investment. In other words, it would not be a probate trust in the accepted sense. If a settlor's requirement is for "income" only, i.e. a stream of payments, then a Loan Trust or a DGT is probably more appropriate.

For those whose main aim is to use the nil rate band on death then straightforward will trust planning will now probably be more appropriate (please see below).

Pre-2006 Budget trusts

These can continue without any change - there is usually no change anticipated in the beneficiary entitled to income during lifetime (i.e. the settlor) - until the death of the settlor.

Will trusts

Will trusts are often set up as discretionary trusts but can be set up on a different basis.

The following is what is reflected in legislation...

- Life interests created in wills remain outside of the discretionary trust regime with the person (not necessarily the spouse/civil partner of the testator) who has the life interest being treated as having an interest in possession, regardless of whether an absolute interest arises on the death of the life tenant or there is power of appointment. These are known as "Immediate Post-Death Interests (IPDI)". However, these provisions only apply during the lifetime and on death of the original life tenant. On the other hand, a change of a beneficiary entitled to an IIP under a flexible power of appointment will trust (during the lifetime of the original beneficiary) will mean that the new IIP will no longer be an IPDI and so the trust will be then subject to the IHT discretionary charges. These factors will need to be fully taken into account in determining the most appropriate trust to use in nil rate band planning.

- When a trust is created in a will or on intestacy in favour of a minor child of a deceased parent, there are now two possibilities. If an absolute entitlement vests at 18 (as under the original proposals), the trust is referred to as a "trust for a bereaved minor". Such trusts are never subject to the IHT charges. The original proposals were also amended to allow vesting at any time between 18 and 25 and this is the second possibility. This is now referred to as "age 18-to-25 trusts". Here, the tax position will depend on when the child actually receives the benefit. If the benefit vests at 18, no charge will arise at that time. If the trust continues after age 18, at 18 the trust will become subject to the discretionary trust regime for IHT purposes, but there will be no 20% entry charge. The result is that if the child becomes entitled at the latest time (i.e. at 25) then the discretionary regime will apply, but with the trust treated as starting when the beneficiary attained 18. The result of this is that the maximum charge that can arise when the beneficiary becomes absolutely entitled at 25 is 4.2% which is 28 quarters (seven years) into the first ten-year trust period. If the beneficiary becomes entitled, say, at 19, then the maximum charge would be 0.6%. i.e. one tenth of 6%. It should also be noted that it is the value of the trust property at the creation of the trust that is taken into account in determining the value deemed to have been transferred for the purpose of determining the rate of tax payable on the settled property.

Of course, if the value of the gift to this trust on death, plus the cumulative total of chargeable transfers made by the deceased in the seven years prior to death, is less than the nil rate band applicable when the beneficiary becomes entitled there will be no charge.

Business trusts

These are typically based on a flexible or discretionary trust. If the arrangement is made on a fully commercial basis between the partners/co-shareholders, no transfers of value take place when the trusts are set up and when premiums are paid and there is no reservation of benefit, even if the settlor can benefit under the trust, say on leaving the business. This does not change post-2006 Budget

With regard to any periodic and exit charges, these arrangements are settlements. However, given that typically the policy held subject to a business trust would be a term assurance policy (or a "no surrender value" whole of life policy), a periodic charge would generally only arise after the sum assured is paid on death/ critical illness and remains in the hands of the trustees until distribution. The exception to this would be those cases where the life assured is in serious ill health and so the policy has a value, say at a ten-year anniversary. Minimising the risk of such a charge under the current legislation should be relatively simple by splitting the cover into a series of separate "sub nil rate band" trusts established on different days so that each has (in most cases) its own nil rate band.

Pre-22 March 2006 business trusts continue to be treated in the same way as ordinary flexible POA trusts. Care needs to be exercised, as, under some trusts,

there is an automatic provision for a change of default beneficiaries (i.e. beneficiaries with an interest in possession) on changes of business partners/shareholders. Such an automatic change would have the effect of bringing the existing trust into the new provisions if this takes place after 5 October 2008 other than on the death of a beneficiary with the trust continuing. But, again, unless the policy had a significant market value there would probably be no detrimental IHT consequences and splitting the arrangement into separate policies/trusts (please see above) would also help to provide further protection against any charge arising. Of course, a change of beneficiaries by the trustees exercising their power of appointment would have the same effect, but here the trustees would have an opportunity to consider the IHT implications of making any change and exercise their power only in appropriate circumstances (say shortly before the distribution of the proceeds).

Summary

The post-2006 IHT rules for trusts have had a significant effect on life assurance business written under trust. Clearly, all pre-March 2006 trusts that could, in practice, have been affected by the new provisions, should have been reviewed to evaluate the impact of the changes. In some cases, urgent action would have been necessary, but for most there was a period (to 5 October 2008) to reorganise their affairs if necessary.

Since 22 March 2006, advisers have needed to know a lot more about the taxation of discretionary trusts – something that previously had been usually left for the professional advisers to deal with, as, in practice, one hardly ever had to deal with working out IHT for a discretionary trust.

Knowledge of how the discretionary trust rules apply is absolutely critical for estate planning practitioners. Given its relative complexity this understanding represents an excellent opportunity to differentiate based on what you know.

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