The options available to a testator (and their implications) who wishes to defer the inheritance of his minor beneficiaries beyond their 18th birthday

"Welcome to the most difficult environment that we as tax practitioners have ever encountered in the UK." So stated Malcolm Gunn in July 2006, in his examination of the Revenue's reasons for completely overhauling the tax regime applicable to trusts and particularly, trusts for young children. As a result of this overhaul, the options available to a testator in this scenario have not necessarily been narrowed, but they have been made significantly more complex. He, like many others, would not wish to disenfranchise his children of their aspirations, and possibly worse, their health, by leaving them a significant legacy at the tender age of 18. However, the traditional vehicle for deferring the legacy, the accumulation and maintenance trust, can no longer be formed from 22 March 2006. In this article I will examine the options for its replacement.[1] Of course, the revenue's changes did not just affect A&M trusts, and it will be necessary to consider systematically the changes affecting other types of trust, in order to examine the options available.

Why a trust?

Before examining the rules, a quick explanation is due. A trust is an independent legal entity whereby the legal ownership, held by the trustees, is separated from the beneficial ownership, held by the beneficiaries. This is therefore an ideal device for deferring the entitlement of minors to a gift. Often a trust will be set up in a will. Part of the process of explaining a Will to a testator is ensuring that he appreciates the possibility of a trust arising under his Will even

[1] The conversion of A&M trusts is outside the scope of this paper.

without his prior contemplation, where for instance he and his wife die before the children attain 18. Simultaneously it should be explained that trusts can also be set up inter vivos, and part of the new difficulty inherent in explaining the rules to a testator is that there is now an anomaly between the taxes due on a lifetime trust and one set up by will. In examining the options available, this paper will address gifts both by will and during the testator's lifetime.

New trusts from 22 March 2006 - "Privileged" vs. "relevant property trusts"

The default position for any trust will now be that it forms "relevant property" and is subsequently subject to the tax charging regime formerly applicable only to discretionary trusts. This operates by means of a charge to tax on creation (if lifetime) of 20%, a ten yearly charge at a maximum rate of 6% and interim exit charges at a proportion of that charge. The testator's nil rate band applies to reduce the sum chargeable to tax. These charges are categorised as inheritance tax but are actually more like a rent or punitive tax for the use of the trust structure.

Certain trusts will be exempt from the above regime, the main exceptions being:

(i) "Disabled Trusts" for a beneficiary categorized as disabled under the legislation and subject to certain further rules (s89B) (This is also the only type of trust exempt even if set up during the testator's lifetime).

(ii) Bare trusts

(iii) A "Bereaved Minors Trust"

(iv) An "18 to 25 Trust"

(v) An "Immediate post death interest" (IPDI)

Disabled trusts will not be appropriate for most testators and are therefore outside of the scope of this paper. Bereaved minor trusts are irrelevant to our hypothetical testator as they can only be for his minor child who will become absolutely entitled to the trust fund at 18. They are also widely held to be less favourable than bare trusts, (which can be for both parents and grandparents). Therefore, the starting points for a consideration of the testator's options are 18 to 25 trusts, IPDIs and relevant property trusts or any possible combination of these three categories.

An 18 to 25 Trust

These trusts may only be set up by Will and must be for the testator's children only (which includes step children and children for whom he has parental responsibility) i.e. not grandchildren. This is similar in one respect to the accumulation and maintenance regime in that for those trusts 25 was also the oldest age of entitlement to capital. The trust remains free of inheritance tax liability while the beneficiaries are under 18. If the funds are appointed out to them on or upon attaining that age, no charge will arise on that event. If the trust runs on after the testator's children attain 18, then it must comply with the rules set out in new s71D of IHTA 1984. Apart from the age requirement above, up until the age of entitlement, the beneficiary must either have an entitlement to the income, or it must be accumulated for his or her benefit and no one else's. During the seven years between 18 and 25 reduced charges will apply. These mirror the relevant property charges mentioned above, but are reduced proportionately to reflect the maximum length of 7 years until the beneficiary attains a vested interest, which amounts therefore to a maximum rate of tax of 4.2% instead of 6%.

It is also worth noting the capital gains tax implications. The exit charge brings into operation the CGT hold-over relief provisions of TCGA 1992 s260. For the avoidance of doubt, Schedule 20 of the Act provides that holdover relief will be available when the child becomes absolutely entitled.

The advantages of using such a trust are as follows. First, no inheritance tax liability arises on the death of a beneficiary under 25. Second, the trust funds will pass according to the terms of the trust and not those of the beneficiary's will or intestacy, should he die before attaining a vested interest. However, since the possibility of a child dying under that age is very remote, these are arguably insignificant. Third, there is a reduced charge of 4.2% which, as is shown below, is not necessarily as favourable as the regime applicable to IPDIs.

The disadvantage of using such a trust is that if the testator has, say, three children under 25, his gift to them must be in fixed and unalterable shares. This reduced flexibility, unable to take account of differing circumstances of each child, will not apply to relevant property trusts.

An immediate post death interest (IPDI)

This is an interest in possession or "life interest" trust. All life interest trusts are now relevant property trusts for inheritance tax purposes unless they qualify as in IPDI. In order to do so, the life interest must originate in a Will and not as the result of an inter vivos gift. Hence, the "immediate post death" interest, which must arise immediately post death (and not several years subsequent as a result of an intervening life or other interest).

Although it was probably envisaged by the legislature that an IPDI would be normally utilised to give property rights to a surviving co-owner, it may also be an attractive option for minor beneficiaries. A testator could consider providing for the IPDI to take effect for the minors on the death of the surviving spouse (the latter first being given an outright gift of residue, otherwise the trust for the minors would be a relevant property trust). This gives the minors a right to all interest from the trust assets immediately, but without any right to capital. A suitably drafted express power to advance capital to the life tenant(s) should be included in the Will. Of course, this power is given to the trustees and the beneficiary would have no power to determine the timing of capital advances[2]. Hence, the trustees have quasi discretionary status without suffering the ongoing relevant property charges. Furthermore, the trust does not simply have to be for the testator's children in order to gain the tax advantages, and so may particularly benefit grandparents who do not wish for their legacy to fall subject to the relevant property regime.

The first disadvantage of using such a trust is that the assets would be taxed as part of the child's assets should he die. However, the tax risk is no greater than a trust where the child becomes entitled to capital at 18, whereby the monies would be taxable in the child's estate in any event. If this is genuinely felt to be a risk then insurance may be available, and perhaps a "disabled trust" would be suitable.

The second disadvantage, more pertinent for larger trusts, is that there is no way to limit the right of the beneficiaries to income, which, if substantial, may not amount to a sufficiently significant deferment of their interests. A view will have to be taken in all cases. Suitably drafted trustees

[2] A suitably worded letter of wishes should be drafted.

powers should allow trustees to invest in high capital growth, low income investments as an alternative strategy.

The third, and probably biggest disadvantage is the charge to capital gains tax which will arise on the advancement to the beneficiary, which could have the unfortunate result of greatly exceeding the exit and tenth anniversary charges to IHT that the IPDI was intended to avoid. It is clear that capital gains tax holdover relief will not be available to defer the tax, which should be seen as a high risk if the grandchildren are particularly young and subsequently a long period could pass before they become entitled.

A discretionary (relevant property) trust

As set out above, all trusts that do not qualify for the privileged status outlined above, will consist of relevant property and will be subject to inheritance tax charges at the appropriate times to the extent that assets within them exceed the nil rate band. Presuming a complete u-turn by the chancellor is not forthcoming, the introduction of the transferable nil rate band in the pre budget report of 11 October 2007 has removed the previous, widely used, tax planning advantage of discretionary trusts.[3] However, that does not make them any less relevant in terms of estate planning. In fact, the more sanguine practitioner will view the changes with some satisfaction, as he may now focus on the flexibility aspect of these trusts, as opposed to their utilisation in tax planning that went beyond the cognition of many a testator (and surviving spouse). Put simply, these remain a very useful trust vehicle for the testator who is concerned that "the three D's" death, divorce and debt, may affect his children and grandchildren's inheritance. Such concerns demand for a more sophisticated approach than an outright gift at eighteen. Many practitioners

[3] To preserve the nil-rate band of the first to die in a married couple or civil partnership.

espouse the usefulness of these devices, should the circumstances call for it. Now that they will be less commonly relevant for tax planning purposes, it will be refreshing to explain them without the testator losing the thread as a result of the intricacies of the debt and charge scheme. The focus can be on the fact that the trustees have complete discretion (i.e. control) over payments of both income and capital to any of a number of beneficiaries. As a result, the death, divorce[4] or bankruptcy of one beneficiary will not threaten the entitlement of another. Moreover, the trustees can determine who has the greatest need and make appointments accordingly, rather than being bound by the obligation to make equal distributions.

That said, there are some financial reasons to use this type of trust, they remain a good way of avoiding care charges, subject to the usual caveats about intention and the assessment of resources regulations. Furthermore, for those clients lucky enough to hold substantial assets qualifying for 100% business or agricultural relief, the discretionary trust may be very good planning. There will be no relevant property charges on the assets within the trust and the relief will have been secured. If they are simply gifted to the surviving spouse then he or she may no longer be eligible to claim the relief at their point of death.[5]

Having determined the general merits of three main ways to defer entitlements on death, this is a good point at which to stop and consider ways in which basic lifetime planning (and perhaps not so basic) can suitably interact with the above options.

Lifetime gifts

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[4] Subject in some limited respects to the jurisdiction of the family court.

[5] BPR is not available on the first ten year anniversary.

As mentioned, all lifetime gifts into trust will be subject to the tax regime for relevant property trusts, subject to the one exception for disabled trusts. However, subject to there being sufficient capital remaining for the testator's own requirements, gifts up to the nil rate band can be made without the charge to tax. The donor should note that, unlike trusts set up in a will, a hefty 20% charge will apply to the value settled to the extent that it exceeds the allowance. This means that gifts in excess of the nil band should almost always be avoided. [6] However, for the wealthier testator, there three "upside" options. First, once seven years have elapsed a fresh nil band will be available as the previous gift will pass from being "potentially exempt" to exempt. Second, spouses and civil partners may each make gifts to the same trust (or indeed, a different one) as that trust will be treated as two separate trusts for IHT purposes under s 44 IHTA 1984. This means that over fourteen years, at current rates, a couple can gift well over one million pounds without any liability arising. Bear in mind of course that to the extent that assets grow beyond the threshold, tax would be chargeable, but at 6% in the hands of the trust, that is far better than forty percent in the hands of the testator on death. Furthermore, each trust will have its own allowance for capital gains tax, thus allowing more family investments to be liquidated on an annual basis without a CGT charge applying.[7]

For the testator interested in more complex planning, loan arrangements, pilot trusts, and, for companies not qualifying for 100% BPR, deferred share arrangements may be considered.

Conclusion

[6] Except where assets qualify for 100% business or agricultural property relief.
[7] And CGT holdover relief should be available.

In summary, both the discretionary trust and an IPDI contain no restrictions based on direct parentage. The IPDI has an advantage in that it is not subject to ongoing tax charges, but suffers from the requirement to pay income without discretion. This may be seen as a disincentive to go out and earn an income! The absence of holdover relief may also prove off putting. As always, there are pros and cons involved in the testator's choice. If the testator is sure that 25 is a good age for absolute entitlement, but does not wish for all income to be paid in the meantime, an 18-25 trust is preferable. If he is mostly concerned to prolong capital entitlement and wishes to avoid tax charges, particularly for older grandchildren, an IPDI would be more suitable. However, for placing the ultimate control in the hands of trustees a discretionary trust remains ideal. In all cases, should he be lucky enough to afford making gifts without reserving any benefit, he can set up any of the above trusts during his lifetime, taking care not to go beyond his allowance.

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