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NEW RULES FOR TRUSTS

The major change for tax-planners arising out of the Chancellor's 2006 Finance Act was to make transfers of assets into most types of trust chargeable to Inheritance Tax.

There are two main categories of trust – those under which one or more beneficiaries have a 'vested interest' – i.e. the right to benefit from the trust; and those which give the trustees the power to decide which of an often broadly-defined group of people should benefit.

Within each of these categories there are two main types of trust. Vested interest trusts can be either Interest in Possession trusts, under which a beneficiary has the right to receive the income from the trust as and when it arises; or Bare trusts, under which the beneficiary has an immediate and absolute right to both income and capital.

The Bare trust is often used by parents wishing to designate property for the benefit of their children, who would be able on reaching the age of 18 to demand that the trust property should be transferred into their own name as absolute owner.

The two main types of trust in which beneficiaries have no vested interest are Discretionary trusts and Accumulation and Maintenance ('A&M') trusts. A&M trusts are a species of Discretionary trust for children, under which the beneficiaries must attain a vested interest by no later than age 25.

Prior to the 2006 Budget, transfers of money or property to all trusts other than Discretionary trusts were classed as Potentially Exempt Transfers. That is to say, they would not incur a charge to Inheritance Tax unless the person who set up the trust died within seven years of doing so.

This situation has now been turned on its head, and transfers to all types of trust other than Bare trusts are classed as chargeable transfers. If the transfer takes place

during the lifetime of the 'settlor' of the trust, tax will be charged at 20% and there will be additional 'periodic' charges of 6% at 10-yearly intervals and exit charges when property leaves the trust. If the transfer into trust takes place under the terms of a Will, tax will be charged at the full rate of 40%.

There are, however, a number of exemptions, which have gained in importance now that the tax net has been broadened. The most important of these is the 'nil rate band', currently £285,000. Any transfer of less than this value, whether during the settlor's lifetime or under a Will, will be charged at 0%; and any transfer of a greater value will only be charged on the excess over the nil rate band - though in calculating this figure account will be taken of any other chargeable transfers made within the previous seven years.

The other notable exemptions are the £3,000 annual exemption and the exemption for regular payments out of income (which will usually cover the cost of premiums on any life policy taken out to fund an Inheritance Tax bill on death).

Transfers to Bare trusts are still classed as Potentially Exempt Transfers, as are outright gifts. Unlimited sums may be disposed of in this way, which will escape Inheritance Tax altogether provided that the donor lives for more than seven years after making the transfer. However, it is entirely possible that this window of tax planning opportunity may be closed in a future Budget, in accordance with the Labour Party manifesto.

Another opportunity which may prove short-lived is that of Business Property Relief (see overleaf). This provides 100% exemption from Inheritance Tax for investments in fledgling companies which are quoted on the Alternative Investment Market (AiM). However, this is likely to be appropriate only for the more sophisticated investor.

Trusts will continue to have an important role to play in personal financial planning, particularly in situations where the objective is to provide a financial benefit without relinquishing control of assets. The protection of the interests of children following a divorce is a recurring example. However, fewer Interest in Possession and A&M trusts are likely to be set up in future, and benefactors are likely to prefer Bare trusts or Discretionary trusts (which provide greater flexibility than vested interest and A&M trusts and for which the tax rules have not changed).

The attractions of establishing nil rate band Discretionary trusts under Wills remain, and this will continue to be a popular way of saving tax by ensuring that each spouse makes full use of their own nil rate band. However, this has become a complex area and it is vital to take expert professional advice.

There are transitional provisions for existing trusts. The previous rules will continue to apply to IIP trusts until the current beneficial interest comes to an end and there will be no new tax consequences if the property then ceases to be subject to the trust.

A&M trusts will be spared the tax charge if they provide, or their terms are changed before 6 April 2008 to provide, that a beneficiary will receive an absolute interest in capital by the age of 18; but if the previously standard age of entitlement of 25 is retained, an exit charge of 4.2% will be levied. This implicit encouragement to permit young people to benefit at age 18 has been widely criticised on the ground that many are insufficiently responsible at that age to manage their financial affairs sensibly.

We appear to be moving to a situation where every means of avoiding tax is being regarded as a loophole which needs to be blocked. The message must be to make use of existing concessions while they remain available.

OFFSHORE CASH

The European Savings Tax Directive was introduced on 1 July 2005 with the objective of ensuring that taxpayers declare and pay tax on their foreign deposits.

The Directive requires EU member states and a number of non-members either to report interest paid on savings accounts to customers who are resident in another member state to the tax authorities in that state or alternatively to impose a withholding tax on the interest. This will enable the UK's Revenue & Customs to double-check the information provided on UK taxpayers' self-assessment forms.

HMRC has expressed its intention to take full advantage of its powers under the Directive and the first example of its determination has been to secure a court ruling requiring Barclays Bank in Guernsey to hand over details of UK resident customers' accounts.

People with money abroad which is in excess of their banking needs can avoid the necessity to report interest by placing their funds in an offshore Investment Bond. The Financial Times has reported that this arrangement is proving popular.

Like on-shore bonds, off-shore bonds permit the return on the cash or other investments held in the bond to be rolled-up and capital to be withdrawn at the rate of up to 5% a year without any immediate tax liability. Tax only becomes payable if the investment is encashed, if more than 5% p.a. is withdrawn, or if the last person on whose life the bond was written dies.

This means that the investor is usually able to choose when to be taxed, and will normally choose a time when they are in a lower rate tax band or may have become non-resident (in which case no UK tax may be payable). Meanwhile, because the providers of these bonds are based in tax havens, no tax will be paid on income and gains received within the bond.

A further advantage is that until tax becomes payable there is no requirement for the investor to render a UK tax return; and when a return is required the procedure is greatly simplified because the insurance company will send a certificate to the policy-owner detailing the relevant figures, and will usually also send a copy to the UK Revenue.

WITH PROFITS SWITCHES

All investments should be reviewed at regular intervals to make sure that they remain suitable to investors' needs, but the financial regulator, the Financial Services Authority, has suggested that there may be a particular need to review With Profits policies.

Historically, the With Profits concept arose out of the fact that many mutual insurance companies tended to generate better returns on their investments than they were required to pay out. So they paid the excess to their long-term policyholders as a bonus when their policies matured.

Today, there are very few mutuals left and savers are frequently unwilling to lock themselves into very long-term investments. This, combined with stockmarket volatility and the effect of regulation in requiring insurers to provide greater reserves to cover their liabilities, has removed the cosy assumptions about With Profits and underlined the advisability of comparing existing policies with the alternatives which are now available.

Clearly this is not a straightforward task, and it requires the attention of a qualified financial adviser. So, what are the steps which he or she would take?

1. The first step is factfinding – establishing the terms of the policy or policies in question.
2. Reviewing the financial strength of the provider and the strengths and weaknesses of their product.
3. Reviewing the investment content of the fund and estimating the potential future return.
4. Noting whether the fund is open to new business or is a 'closed' fund.
5. Relating the risk characteristics of the product to the current circumstances of the policyholder.
6. Establishing whether any costs or penalties would be incurred by encashing the policy and whether these might be reduced by doing so at a particular anniversary date.
7. Comparing the risk and return profile of any alternative investment.

Some With Profits policies are perfectly sound and offer attractive potential for the long-term saver, but many have become lame ducks and, depending on the time span to maturity, investors may be able to achieve better returns elsewhere.

WHAT A RELIEF!

Business Property Relief ('BPR') is one of the main tax breaks available to business owners. It provides relief from Inheritance Tax for qualifying business assets which could reduce the taxable value of a business to nil.

For a transfer of property to attract 100% BPR it must relate to a business or an interest in a business or to unquoted shares in a trading company (which expression includes shares which are traded on the Alternative Investment Market). A business is defined as a trade or profession carried on for gain, so 'hobby' businesses would be excluded. Certain other types of business are also excluded, notably those whose principal activity is dealing in securities or land and buildings.

Complications can arise over mixed businesses. In the case of *Farmer v IRC* (1999) the issue was whether a landed estate which conducted both farming and letting activities should be eligible for BPR. The Tax Commissioner took account of the capital employed in the two parts of the business, the allocation of turnover and profit, and the time spent by directors and employees, and held that the letting of properties was subsidiary to the main farming activity and that BPR should therefore be available for the whole business.

If a business holds cash, stocks or shares, land or buildings for personal use or investment purposes, these will be left out of account for the purposes of BPR. It may sometimes be difficult to tell whether cash, in particular, is earmarked for a specific business purpose or is simply being accumulated as a financial reserve. Clearly it is vital to keep accurate records of management decisions.

Exchange between economist J K Galbraith, who died recently, and President John F Kennedy:

Galbraith: "You wouldn't call me arrogant would you?"

JFK: "Why not? Everybody else does"