



THE FINANCE ACT 2006 & THE TAXATION OF TRUSTS

After much controversy The Finance Bill finally received Royal assent in August 2006. Although the Government backed down on some of its original proposals for this Bill, the main intentions of many of the proposed changes remain in place.

General Trust Tax laws means that Trusts are potentially subject to Inheritance Tax (IHT) when they are first set up (entry charge – maximum 20%), when assets leave the trust and are distributed to the beneficiaries (exit charge – maximum 6%) and at every 10th anniversary of the trust (periodic charge- maximum 6%). However it is important to note that these charges **only** apply to assets which **exceed** the Nil Rate Band (NRB) allowance.

Before the Finance Act this regime was only applicable to Discretionary Trusts. Now all trusts are treated in accordance with these taxation rules, with the following exceptions:

1. Trusts established from a Will for the benefit of a child. Where the age of inheritance is specified as 18 – there is no further taxation applied and these are known as “**Trusts for Bereaved Minors**”. Where the age of inheritance is between 18 and 25 then a reduced rate of tax is applied on exit of these “**Age 18-25 Trusts**” as a proportion of the 6% of the 10 year charge. This means that after 7 years, at 25, a maximum of 4.2% charge will be applied on assets which exceed the NRB. Note that

this would be in addition to any tax payable at 40% above NRB on the testator’s estate prior to the assets going into the trust. The tax advantages of these types of trusts do not apply to any additions made to the trusts, post creation;

2. **Trusts for Disabled Beneficiaries** will not be subject to further taxation, although there are strict definitions for test of disability;

3. Life Interest Trusts created either from a Will or intestacy will be known as an **Immediate Post Death Interest Trust (IPDI)**, these also receive favourable IHT treatment.

The good news is there is no change to the taxation of Nil Rate Band Discretionary Will Trusts. These are still an excellent and relatively cost effective way of saving IHT without compromising the family home. Note that where there may be an artificial debt (i.e. where the house is owned solely and a transfer of equity is made), an independent trustee should be used and not the spouse. The charge route is used to secure the IOU is usually implemented to protect the estate from CGT and there is no SDLT (which gets round the possible artificial debt). The loan note is used if the value of the loan is below the 1% SDLT charge.

All Will trusts other than those mentioned above and created after March 2006 are known as “**Relevant Property Trusts**”.

Wills that give the residue estate as a life interest trust to spouse (IPDI) – the old rules still apply and spouse exemption still exists. However, where the life interest is terminated by spouse or trustees, and the residue passes to an individual or bereaved minor or into a disabled trust, then it is treated as a Potentially Exempt Transfer (PET).

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Therefore “Estate Preservation” clauses in Wills which have a remarriage or co-habitation clause for spouse, which if enacted, passes to children, then the termination of the life interest is treated as a PET from spouse to children. If the clause is termination of life interest on death only and not remarriage etc, then is included back into estate of spouse and old rules apply.

An IPDI can only happen on death as part of a Will trust. A trust created outside a Will is not an IPDI – e.g. Children’s settlements do not apply and no longer have any tax advantage. Similarly, all accumulation and maintenance trusts will now be subject to the new regime unless, before April 2008, the trustees take steps to bring the trusts to an end on the 25th birthdays of the beneficiaries.