Inheritance tax: choosing the right sort of trust to provide for partners, children and minors

Inheritance tax and trusts

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In the first of two articles on providing for partners, children and minors by will, we examine how to identify the right sort of trust.

Key Points

What is the issue?

Testators have a range of possible trusts that can be used for partners, young children and grandchildren in their wills, including an immediate post-death interest, trusts for bereaved minors, and age 18-to-25 trusts.

What does it mean for me?

Because the inheritance tax treatment differs, it is necessary to provide for which form of trust takes priority over another.

What can I take away?

There is often confusion about what regime a will trust falls into, which can result in some missteps in calculating the appropriate capital gains tax and inheritance tax regimes to apply.

Types of will trust

Even after the changes to the inheritance tax treatment of trusts that were made in March 2006, testators have a range of possible trusts that can be used for partners, young children and grandchildren in their wills. These are set out below and are only available to property passing on death.

A qualifying interest in possession trust

This is an immediate post-death interest, where the property must be settled by will on death, in which the trust property is for inheritance tax purposes treated as belonging to the relevant beneficiary (see Inheritance Tax Act 1984 s 49(1)). This gives the beneficiary a right to income (even if revocable) and there may (but need not) be power to advance capital to that beneficiary. It is not limited to a particular class but can be used for any individual.

Trusts for bereaved minors

This is only available for minor children of the testator (see Inheritance Tax Act 1984 s 71A). The key limiting feature of these trusts (known as Section 71A trusts) is that they can only be set up in favour of a minor child of the testator by will or intestacy (hence they cannot be set up for grandchildren by will). There is no inheritance tax payable on the death of a child under 18 or on the child reaching 18.

The terms must provide that the child takes capital at 18 but can take entitlement to income before that age. Before reaching the age of 18, capital entitlement can be deferred indefinitely, in which case there is no entry charge but the trust is now within the relevant property regime. If capital entitlement is deferred until the age of 25 under Inheritance Tax Act 1984 s 71D, the trust enters the s 71D regime, again with no entry charge.

Age 18-to-25 trusts

Known as Section 71D trusts, again these are only available for children of the deceased parent set up by will. The children must take capital no later than the age of 25 and in practice must not be entitled to income within two years of death. The price to pay is a maximum 4.2% charge on reaching 25. There are no ten year charges unless the trust terms are changed to defer capital beyond 25.

Other trusts

Other trusts that can be used for partners, young children and grandchildren include a bare trust and a discretionary trust (a relevant property settlement).

Priority and implications of having different types of trusts

There is some overlap in the different types of trust listed above. Because the inheritance tax treatment differs, it is necessary to provide for which takes priority over another. The ‘pecking order’ of trusts is as follows:

1. The bereaved minor trust (Section 71A trust): This takes priority over all others.
2. The immediate post-death interest: Any person takes an immediate right to income on the death of the testator.
3. The 18-to-25 trust (Section 71D trust): The child of the deceased parent must take capital and income no later than the age of 25.
4. The relevant property trust.

What is the position if the parent’s will gives the minor an immediate right to income (Trustee Act 1925 s 31 is excluded) with capital vesting at the age of 18? Is that a bereaved minor trust or an immediate post-death interest?

Inheritance Tax Act 1984 s 49A provides that if the conditions of Section 71A are met, the interest in possession is not an immediate post-death interest (i.e. the bereaved minor trust rules take precedence). However, if the will gives the minor **grandchild** or another beneficiary an interest in possession with capital vesting at the age of 18, it **will** be an immediate post-death benefit. Also, if the will gives the child an immediate right to income and defers capital entitlement until the age of

25, this is an immediate post-death interest, not a Section 71D trust.

Hold-over relief or not?

There is often confusion about what regime a will trust falls into, which can result in some missteps in calculating the appropriate capital gains tax and inheritance tax regimes to apply. Hence, a will trust for ‘my children at 25’ – giving them an immediate entitlement to income on death – is an immediate post-death interest, not an 18-to-25 trust (Section 71D). A will trust giving ‘capital to my children at 18’ – but giving them income entitlement within two years of death while still minors – is a bereaved minor trust not an immediate post-death interest.

Beware the effect of Inheritance Tax Act 1984 s 144 if, say, settled property is held ‘on trust for my children living at my death in equal shares at 25’, and one child is 18 at the testator’s death or becomes 18 within two years of death. Unless Trustee Act 1925 s 31 has been modified, the child takes an immediate post-death interest, not an 18-to-25 interest. Section 144 provides for automatic reading back. The fact that the trustees have not exercised any powers is irrelevant. However, if the child is appointed entitlement to income within two years of death and the will specifies that they become entitled to capital at the age of 18, the trust remains a Section 71A trust. This is in accord with the pecking order above.

Why do we care?

The type of trust has inheritance tax implications. On the death of a child under the age of 18 with a bereaved minor trust there is no inheritance tax; but with an immediate post-death interest there is! Furthermore, if the trustees exercise their powers to defer absolute entitlement as a child approaches the age of 18, there is no exit or entry charge at that point if it is a bereaved minor trust (or Section 71A) trust being converted. However, there would be an entry charge if, say, the beneficiary (such as a grandchild) had a qualifying interest in possession which was an immediate post-death interest.

It also has wider implications. For example, Section 71A and Section 71D trusts do not automatically need to go onto the Trusts Register provided the trustees have no UK tax liability.

Hold-over relief under the Taxation of Chargeable Gains Act 1992 s 260 is available on advancements of assets out of a Section 71A or Section 71D trust to the beneficiary on or under the age of 18, even though there is no exit charge; and also on advancements of assets out of a Section 71D trust to the beneficiary after the age of 18, as there is an exit charge then. However, no hold-over relief is available under s 260 if there is an outright advancement from an immediate post-death interest trust. Practitioners may wrongly submit an IHT100 form at the ten year anniversary if they think they are dealing with a relevant property trust rather than a Section 71D or immediate post-death interest trust.

Spousal immediate post-death interest trusts

In cases where the will of the first spouse or civil partner to die leaves residue on an interest in possession trust for the surviving spouse or civil partner (an immediate post-death interest), it should provide for trusts over to take effect on the ending of that spouse or civil partner’s interest. These trusts can qualify as Section 71A (bereaved minor) or Section 71D (age 18-to-25) trusts but it is not possible to create successive immediate post-death interests.

However, if the will provides for residue to be held on trust for the surviving spouse or civil partner and then for the children on interest in possession trusts, the trusts for the children will be taxed under the relevant property regime and the surviving spouse will make a chargeable transfer (not a potentially exempt transfer) if the spousal interest is terminated or surrendered inter vivos.

Testamentary general power of appointment

If the surviving spouse is keen that the children should take immediate post-death interests on his or her death, the trustees might advance the capital out to the surviving spouse. That spouse could then set up immediate post-death interests in their will for the children.

Alternatively, the spouse could be given a testamentary general power of appointment which they exercise in their will to create immediate post-death interest trusts for the children.

If the trust property is or includes the principal residence of the surviving spouse (or a share of it), the children need to become absolutely entitled to it on the death of the surviving spouse for their inheritance of it to qualify for the residence nil rate band, unless the surviving spouse has a general power of appointment which is exercised by will to create a new settlement of the property which gives the children qualifying interests (immediate post-death interest, Section 71D or Section 71A).

Immediate post-death interest followed by potentially exempt transfers

If the deceased leaves residue on immediate post-death interest trusts for the surviving spouse or civil partner and the survivor wishes to terminate that life interest inter vivos and make potentially exempt transfers for the children, the children must either take outright or on bereaved minor trusts.

Hence, it is not necessary that the terms of the bereaved minor trust are set out in the will itself. The trustees may exercise powers of appointment (given to them in the will) to secure that on termination of the spousal immediate post-death interest by death or during the surviving spouse or civil partner's lifetime the settled property is held on a bereaved minor trust.

If later it turns out that the children are not financially responsible at the age of 18, the trustees can exercise a power of advancement to defer absolute entitlement. At that point, the trust will fall into the relevant property regime but without an inheritance tax charge. (The trust could be converted into a Section 71D trust at that point, if it was felt preferable for the children to inherit at the age of 25, not 18. Then just before the age of 25, their interests could be postponed again, at which point the trust would become a relevant property settlement!)

Curiously, while it is possible to convert the spousal immediate post-death interest trust into a Section 71D trust on termination of the spouse's life interest, this would not be a potentially exempt transfer by the spouse but a chargeable transfer. But going into a Section 71A trust and then a Section 71D trust from that would work to avoid an entry charge!

In the second part of her article, Emma Chamberlain will examine how the challenges of identifying the right sort of trust work in practice.

A detailed survey of the technicalities of the relevant property regime, trust and will drafting issues is in the forthcoming 5th edition of Chamberlain and Whitehouse on Trust Taxation.