The practical challenges of identifying the right sort of trust

Inheritance tax and trusts

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In the second of two articles on providing for partners, children and minors by will, we examine how the challenges of identifying the right sort of trust work in practice.

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

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 regime to apply.

Following on from our article in September, we set out some examples of how these issues can work in practice.

Example 1: Adam and Brian

Bereaved minor trust: By his will, Adam leaves property to his son absolutely on attaining the age of 18. Failing that, it is to go to Adam's sister. When Adam dies, his son is aged nine. This is a bereaved minor trust (known as a Section 71A trust). Although there is a substitutional provision in favour of the sister, while the son is alive capital and income can only be applied for his benefit and he takes absolutely at 18.

18-to-25 trust: Brian's will leaves property to his daughter at age 21 with remainders over. Until that age, the trustees have power to use income for her maintenance and to accumulate any balance. He dies when she is nine. This is not a bereaved minor trust. Capital and income vesting is postponed to 21 but it will qualify as an 18-to–25 trust (known as a Section 71D trust) unless the trustees give her entitlement to income within two years of death, in which case it will be an immediate post-death interest.

A deceased parent

The requirement that the trust must be established under the will of a deceased parent can be satisfied:

- if the trusts arise as the result of an instrument of variation of the deceased's will which is read-back under Inheritance Tax Act 1984 s 142(1); or
- if the trusts arise as the result of an event occurring within two years of death leading to a reading-back under Inheritance Tax Act 1984 s144.

An immediate post-death interest involves the beneficiary becoming entitled to the interest in possession on the death of the testator. Unlike an immediate post death interest, it is not necessary that the property becomes immediately held on these trusts at death. A bereaved minor trust can, for instance, be preceded by an immediate post-death interest, a relevant property trust or an 18–25 trust.

If the immediate post-death interest ends during the lifetime of the interest in possession beneficiary, he will make a potentially exempt transfer into the bereaved minor trust (see Inheritance Tax Act 1984 s 3A(1A)(iii)). Contrast the position in the case of 18–25 trusts under s 71D.

Bear in mind the overriding requirement that a bereaved minor trust must be set up by the will or on intestacy of a **deceased parent**.

Example 2: Elizabeth and Emma

Elizabeth died in 2012 leaving her property on an immediate post-death interest trust for her daughter, Emma, who was aged 45. Emma died unexpectedly in 2013 and the property became held on trust for her two minor children in equal shares contingently on reaching 18.

Emma’s children are bereaved minors but the trust is established under the will of their grandmother, not their mother, and therefore on the death of Emma the settled property is taxed under the relevant property regime. If Emma had been given a general testamentary power of appointment, she could have exercised this in her will to give her children qualifying interests in possession and these would have been immediate post-death interests.

Complications and capital gains variations

There are other complications and capital gains variations. For example, hold over relief is available on transfers from a Section 71A and a Section 71D trust (and apparently even if the beneficiary is entitled to an interest in possession). This is the case before or after the beneficiary reaches 18 in the case of a Section 71D trust.

The tax free death uplift is available on the death of a minor child before 18 whether the trust is Section 71A or Section 71D but only if the beneficiary has an actual interest in possession. In the case of a Section 71D trust, this interest in possession cannot be appointed within two years of death; otherwise the trust will be an immediate post-death interest trust not a Section 71D trust. The death uplift will be available on the death of the life tenant with an immediate post-death interest but hold over relief is not available under Section 71D.

On a Section 71D trust, there is no capital gains tax death uplift if the beneficiary dies after 18 but before 25, even if they have a (non-qualifying) interest in possession.

For cases where a will contains more than one set of trusts, a change made by Finance (No. 2) Act 2015 improves matters for relevant property trusts in some circumstances. This is because it is no longer necessary to take account of non-relevant property in the same or related property trusts when calculating the rate of tax applicable to the exit and ten year charges. So if a will has an immediate post-death interest for one child and a discretionary interest for another, the immediate post-death interest property can be ignored in calculating the rate of tax on the discretionary interest. The position is slightly different in relation to Section 71D property.

Bear in mind that Inheritance Tax Act s 144 can also operate to destroy what at first sight would appear to be a Section 71D trust.

Example 3: Roy

Roy dies in 2013. He leaves his entire estate to his three children Alice, Ben and Catherine contingent on attaining 25 and if more than one equally. Alice is 19 when Roy dies, Ben is 17 and Catherine is 14. At 18, each child will become entitled to income (as a result of Trustee Act 1925 s 31).

Position of Alice: Alice has a right to income when Roy dies, which means that her share is held in an immediate post-death interest trust. When she becomes entitled to capital at the age of 25, there will be no inheritance tax charge (Inheritance Tax Act 1984 s 53(2)). Capital gains tax hold-over relief will not be available unless the property is business assets within Taxation of Capital Gains Act 1992 s 165. If Alice dies before the age of 25, the value of her immediate post-death interest fund will be taxed as part of her estate.

Position of Ben: Ben will become 18 within two years of Roy’s death and when this happens s 144 will apply to read-back his entitlement to income to the time of Roy’s death. He too, therefore, will have an immediate post-death interest. Of course, if Ben dies before he reaches the age of 18, the trust for him will satisfy the Section 71D requirements and there is no inheritance tax charge; if he dies after the age of 18 there will be.

Position of Catherine: The trust for Catherine is within Section 71D. Accordingly, an exit charge of up to 4.2% may arise in respect of the period from Catherine becoming 18-to-25. At that time, capital gains tax hold-over relief will be available.

Advice: If Roy had wanted all his children treated the same and had intended the Section 71D regime to apply, the will as drafted in this case is a disaster. This has resulted from the right to income at the age of 18 given by Trustee Act 1925 s 31. It should have been excluded.

The will draftsman should have provided that until the age of 25, the income from each share can be used for the child’s maintenance with any balance being accumulated and added to the share. The alternative is for the trustees to accelerate Catherine’s right to income and appoint an immediate post-death interest to Catherine within two years of Roy’s death. The choice is between a bereaved minor trust and Section 71D – or an immediate post-death interest?

What sort of trust to use?

The immediate reaction of many taxpayers is that they would prefer to postpone capital vesting until the child becomes at least 25, albeit that the trustees will be given a power to advance capital earlier. Further, it might be thought that it will be sensible to draft wills with a Section 71D trust on the basis that by advancing capital at the age of 18 the trustees can, in effect, obtain bereaved minor trust treatment. The Section 71D trust can be extended into the relevant property regime if the trustees decide to postpone capital entitlement even beyond 25 (albeit with the same exit charge as absolute entitlement).

This is broadly correct but the following factors should be borne in mind:

1. Inheritance tax will be chargeable once the trust continues after the beneficiary has attained the age of 18 in accordance with the charging regime in Inheritance Tax Act 1984 s 71F. If the beneficiary dies after the age of 18, there is an inheritance tax charge, unless the property continues to be held on trust for other children of the deceased who are under the age of 25.
2. A potentially exempt transfer will arise on the inter vivos ending of an immediate post-death interest (e.g. for the surviving spouse of the testator) but only if the continuing trust is a bereaved minor trust, not if it is a Section 71D trust when it will be a chargeable transfer.
3. Capital gains tax death uplift is only available if the beneficiary enjoys an interest in possession and dies before the age of 18. (Note that that the top rate of charge is 4.2% at age 25, which some will consider a fair price to pay for

continuing the settlement. But, of course, rates may rise in the future. In fact, the uplift is available whether the trust is a bereaved minor or Section 71D trust and the key features of the relief are that:
a) the beneficiary must enjoy an interest in possession; and
b) must die under the age of 18.

4. For young beneficiaries where it is thought that the age of 25 is too young to take outright particularly on large estates, it may just be better to avoid the relevant property regime altogether. Instead, an interest in possession could be appointed to the children within two years of death, so they take immediate post-death interests which are qualifying interests in possession. No hold over relief is available under s 260 on absolute entitlement but the assets can stay in the trust indefinitely without continuing inheritance tax charges until the death of the child.

One further factor to bear in mind is that a bereaved minor trust can be extended by making a settled advance (assuming the trustees have a full power of advancement) so it becomes a Section 71D trust, which may in turn be further extended beyond 25. The trust may then fall into the relevant property regime after the beneficiary reaches the age of 25 and a wider class can potentially benefit. So in all cases retain a wide power of advancement!

Note, however, that it may be hard to justify a settled advance as being for the benefit of a beneficiary under the age of 25 if as a result of the advance a wider class can benefit. If the testator wants flexibility between siblings and their issue on distributions of income and capital, it is preferable to have a trust within the relevant property regime from the outset.

Generally, it is unwise from the inheritance tax perspective to leave the cohabitee a qualifying interest in possession. It may be better to leave the assets on discretionary trust for that cohabitee. Otherwise there is inheritance tax payable on the first death and then again on the death of the cohabitee. At least if assets are held on discretionary trust, income and capital can be paid to the cohabitee at the trustees’ discretion (the cohabitee can be a trustee) and there will simply be ten year charges.

Check the sort of trust you are dealing with before filing a ten year anniversary charge or exit charge form. It may not always be as you anticipate or even as the deceased intended!

A detailed survey of the technicalities of the relevant property regime, trust and will drafting issues is in the forthcoming edition of *Trust Taxation and Private Client Estate Planning.*