



WING TIPS

Trusts and The Finance Act 2006

You'll probably have seen the headlines over the last few months crying foul at the new Inheritance Tax ("IHT") rules relating to trusts, which were introduced in the Chancellor's last budget. Apart from a few relatively minor changes along the way, those budget proposals became law on 19th July. So what are the changes and how might they affect shareholders in a typical AngelNews business? To understand the changes we need to know a little about the previous position.

Essentially, there have been three main types of trusts for a long, long time – interest in possession trusts, discretionary trusts and accumulation and maintenance trusts. In the case of an interest and possession ("IIP") trust one or more beneficiaries are entitled to any income generated by the assets or to the use of those assets. In the case of a discretionary trust, no one is entitled to anything and the trustees decide which of the potential beneficiaries receives any income or capital. An accumulation and maintenance (A&M) trust is a sort of hybrid, in that it can be discretionary until the beneficiary attains a maximum of 25 yrs of age, then either it must become an IIP trust or the beneficiary must have the assets.

There was no IHT on a transfer of assets into an IIP trust – no matter what their value. In the case of a discretionary trust the value of the assets transferred to the trustees was a chargeable transfer and gave rise to an IHT charge if the value of those assets (and of any other gifts in the previous 7 years) exceeded the nil rate band – which is currently £285,000. In addition, there may well be a tax charge every 10 years and/or on the transfer out of a discretionary trust of some or all the assets (depending on value). There was no IHT charge when assets were transferred to an A&M trust – again, no matter what their value – and there was no 10 yearly or exit charges.

And what has changed? Basically, all trusts are now treated as discretionary trusts in the sense that there is a charge to IHT in respect of assets transferred to the trustees if the value of those assets (and any other gifts made in the previous 7 years) exceeds the nil rate band. Furthermore, depending on the nature of the asset and its value, there may well be a charge to IHT every 10 years and/or whenever assets are transferred out of trust to a beneficiary. This is a very significant change in the treatment of trusts for IHT purposes – but what impact will it have on shareholders in a typical AngelNews company?

Shareholders in a private trading company are in a very privileged position in that the value of their shares doesn't count for IHT purposes if they have been held for at least 2 years. If such shares are held until death there would be no IHT (plus some CGT benefits) and if the shares were sold prior to death there would effectively be a 10% CGT charge. Following a sale steps could be taken to reduce the IHT charge that would arise on death whilst holding a considerable amount of cash (which doesn't qualify for any sort of relief from IHT). Until this year, the most likely course of action would be for the fortunate former shareholder to transfer a substantial amount of cash into a trust for children or grandchildren etc and, provided he/she survived for at least 7 years thereafter, that cash wouldn't be included in the value of assets subject to IHT on death.

However, as a result of the new rules it won't now be possible for an individual to transfer a substantial amount of cash into a trust without triggering an IHT liability. So what should that typical AngelNews shareholder do following Finance Act 2006?

You could do the same as before – keep the shares until death and enjoy the exemption from Inheritance Tax or sell the shares during your lifetime and make an outright gift of cash to children and/or grandchildren etc, again hoping that you will survive for at least 7 years thereafter. But what if the lucky beneficiaries of your generosity are too young or too reckless (or both) to be trusted with an outright gift? It will not now be possible to put a substantial sum of money into a trust without triggering a charge to IHT.

Perhaps the best course of action now is to set up a trust straight away into which the shares are transferred without any IHT liability (because they qualify for the generous business property relief). If, say 10 years later, the shares are sold and there is a substantial amount of cash in the trust there would be no question of going back to the time of the gift into trust and charging IHT – but there might still be a potential problem with the 10 yearly charge and the exit charge.

In summary then, the new rules limiting the tax opportunities with trusts are actually a spur for shareholders in private trading companies to set up trusts earlier than they might otherwise have done and to transfer to the trustees shares in the company rather than, at sometime in the future, the cash proceeds from the sale of those shares. As for those very wealthy individuals whose wealth is not represented by shares in trading companies – the new rules are very bad news indeed!

For further information on trusts and the rules of the Finance Act 2006 please contact Brian Williams at Vantis plc, at brian.williams@vantisplc.com or visit www.vantisplc.com.