TECHNICAL SALES BRIEFING

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FINANCE ACT 2006 AND INTEREST IN POSSESSION (IIP) TRUSTS

KEY POINTS

- The rules with respect to Flexible Power of Appointment (with Interest In Possession (IIP)) trusts created pre-22 March 2006 can be quite complex. It is important to understand whether changes to the IIP beneficiaries today will result in the trust being treated as a relevant property trust for Inheritance Tax (IHT) purposes
- From 22 March 2006, most new IIP trusts will fall into the Relevant Property (RP) regime despite providing for a life interest. There are two exceptions to this general rule. IIP trusts created via a person's will and IIP trusts created for disabled persons
- Trustees should be careful when considering their powers of appointment in relation to pre-22 March 2006 trusts, so that they do not inadvertently change the IHT treatment of the trust itself. This briefing looks at the rules in this area which are quite complex.

THE FINANCE ACT 2006

The Finance Act 2006 introduced legislation that drastically changed the taxation of IIP trusts so that any new IIP trusts created after 21 March 2006 would, with a few exceptions, be subject to the RP regime for IHT purposes. As a result these trusts would be potentially subject to IHT periodic and exit charges; a tax regime which had only previously applied to 'true' discretionary trusts.

BACKGROUND

We perhaps first need to understand the difference between an IIP trust and a discretionary trust. An IIP trust will give a beneficiary the right to receive income during their lifetime. A classic IIP trust would be written to give income to 'beneficiary A' for life, capital to 'beneficiary B' for beneficiary A's lifetime and the remainder to 'beneficiary C' after 'beneficiary A's death. An IIP trust may be drafted in such a way that the trustees can also advance income or capital to the current IIP beneficiary but, very often, the trust will simply leave the capital to other beneficiaries. Some IIP trusts will also allow the IIP beneficiary (the life tenant) to be changed at the trustees' discretion, and this was quite common with trust drafts prepared by life companies. Further, some drafts allowed for successive interests whereby a surviving spouse would take over the life tenancy from their deceased spouse.

In contrast, a discretionary trust is simply a trust whereby the income and capital is held for a list of beneficiaries and the trustees have wide discretion on whom, amongst the class, to appoint the income and/or capital. Some discretionary trusts are drafted with a list of (named) potential beneficiaries whilst others are drafted with classes of beneficiaries, i.e. my spouse, my issue (children) etc. The later type is more common, as it allows for more flexibility on who the trustees can appoint to. Importantly, depending on what assets the trusts hold, IIPs and discretionary trusts are taxed differently for the purposes of Income Tax. We cover the taxation aspects in more detail later in this briefing.

The Finance Act 2006 also introduced some transitional rules to try and soften the blow of the changes. These transitional rules meant that existing IIP trusts were not necessarily affected by the changes, allowing the IIP beneficiary to be changed without implication. Further protection was also given in certain circumstances if the IIP beneficiary under a pre-2006 trust died, with specific rules regarding trusts holding life assurance policies.

We will now look at the position before the Finance Act in 2006 and the position as it stands today.

THE POSITION PRIOR TO 22 MARCH 2006

Prior to the Finance Act 2006, FPoA trusts were the trusts most commonly used in connection with life assurance and capital redemption policies, i.e. IIP trusts where the IIP beneficiary could be changed in favour of other potential beneficiaries. Transfers to such trusts by individuals were Potentially Exempt Transfers (PETs) for IHT (to the extent the transfer exceeded the available IHT exemptions). Under this previous regime the gift into trust was said, for IHT purposes, to be from the settlor to the recorded IIP beneficiary(ies). If the IIP died whilst holding an interest, then that interest would be included as part of their estate. Equally, on an FPoA trust if their interest was passed to someone else by the trustees using their power of appointment this was considered a potentially exempt transfer (PET) from the (previous) IIP beneficiary to the new IIP beneficiary.

As the IIP beneficiary's interest under an FPoA trust was able to be defeated, it was possible that many IIP beneficiaries wouldn't be informed by the trustees (or the settlor) of their beneficial interest, despite the interest falling into their estate for IHT purposes. This situation was perhaps part of the issue with this previous regime as, after all, if the IIP beneficiary didn't know they had an interest for IHT purposes, then it stands to reason their executors wouldn't record their interest on death or if the interest had been passed on and the PET had failed.

TRUSTS CREATED AFTER 22 MARCH 2006 THAT STILL FALL WITHIN THE PREVIOUS IIP REGIME

From 22 March 2006, transfers into most IIP trusts (unless within the categories set out below) are treated as chargeable lifetime transfers and are taxed subject to IHT under the RP regime, i.e. in the same way as transfers to a discretionary trust. This means no single beneficiary is deemed to 'own' the capital for the purposes of IHT and, instead, the trust itself is potentially charged to IHT every ten years and when property enters and leaves the trust.

This is in contrast to the previous treatment of IIP trusts. IIP beneficiaries were deemed to be the beneficial owners of the capital for IHT purposes, and the capital formed part of their estates.

Following the Finance Act 2006, there are still two ways in which a new IIP trust can be created and not be part of the RP regime. The two exceptions are broadly as follows:

1. An Immediate Post Death Interest (IPDI) trust within the meaning of s49A IHTA 1984. An IPDI is a trust whereby on the death of a person, an IIP trust is immediately established for the benefit of named individuals. A typical scenario would be a will trust where the testator / testatrix has provided that the trust be established as an IIP to pay an income to a family member – often a surviving spouse. It is important to understand that an IPDI can only be created on death and thus any lifetime trusts cannot be IPDIs. This exception only therefore extends to trusts created on a person's death.
2. Trust for a disabled person's interest within the meaning of s89B IHTA 1984. The definition of a disabled person is given in Schedule 1A of the Finance Act 2005 and includes:
   - › A person who is incapable of administering his or her property by reason of mental health within the meaning of the Mental Health Act 1983
   - › A person in receipt of the attendance allowance, disability living allowance (subject to conditions), personal independence payment, increased disablement pension, constant attendance allowance or armed forces independence payment.

TRUSTS CREATED BEFORE 22 MARCH 2006 WHICH ARE STILL IN EXISTENCE TODAY

The Finance Act 2006 also included legislation to cover existing IIP trusts that were settled prior to 22 March 2006. The IIP will retain its pre-2006 IHT position until one of the following occurs:

1. **New capital is added to an IIP trust on or after 22 March 2006**. Here the gift of new capital will constitute a chargeable transfer and the proportion of the trust assets secured by the new capital will be within the RP regime. There is one exception to this rule in the case of life policies. Where there is an automatic increase in the premiums as a contractual term of the policy, or where the policy contains an option that premiums can be increased at some stage, or that an additional single premiums can be paid under the terms of policy, this rule will not apply. Note this rule only applies in relation to life policies and not capital redemption policies.
2. **Where the IIP in existence as at 22 March 2006 'comes to an end' and the trust remains in force** with a new IIP beneficiary, it will bring the trust into the 'relevant property' regime. This means that the death of the beneficiary will ordinarily trigger that their share in the property will be RP from the date of their death. Note, where the pre-2006 life interest (IIP) was changed in the transitional period, neither of these rules would apply and the successive interest will create relevant property.

There are then two further exceptions to this second rule which mean the trust will remain under the pre-2006 regime, despite the IIP coming to an end:

- if the trust holds a life policy and the pre-2006 IIP come to an end but passes automatically to somebody else under the terms of the trust (not by the trustees using a power)

  OR

- if the IIP passes on death to the spouse of the previous, now deceased,pre 2006 life tenant. Again, for this rule to apply, the interest must pass automatically to the spouse under the terms of the trust and not by the trustees using their power of appointment. If the trustees have to use their power of appointment because the successive interest is not in the trust provisions, this will still create relevant property.

Broadly, where the trustees make an appointment to end the current IIP, be that in the lifetime of or on the death of the pre-2006 IIP beneficiary or beneficiaries, then the trust will fall into the RP regime. However, where a pre-2006 IIP trusts holds a life assurance (or capital redemption bond) one way to allow the trustees to use their power of appointment to appoint to another beneficiary, but avoid the trust being subject to the RP regime, is to simply assign the bond (or policies) out of the trust to that beneficiary. Such an assignment brings the original IIP to the end, with the trustee distribution being treated, for IHT purposes, as a PET from the (current) IIP beneficiary to the assignee.

Transitional rules also applied for a brief period following the Finance Act 2006; from 22 March 2006 to 6 April 2008 (later extended to 6 October 2008). Here, the beneficiaries could be changed without affecting the IHT treatment of the trust. This opportunity to amend the beneficiaries has obviously now ended but it is important to understand this when applying the above rules.

Where a beneficiary was changed in the transitional period, or as a result of the two rules detailed previously then these are referred to as Transitional Serial Interest (TSIs).

Trustees should be very careful not to make changes to the pre-22 March IIP beneficiary (or the TSI) using their power of appointment whilst keeping the trust in force, perhaps in an attempt to pay 5% withdrawals from a bond under the chargeable event legislation to another potential beneficiary. Such changes to the pre-22 March IIP beneficiary (or TSI) will bring that part of the trust into the RP regime and change the taxation of that proportion of the trust in respect to IHT. At the very least, the resulting trust would have a mixed tax treatment which would make tax calculations very complex.

THE TAXATION OF IIP TRUSTS FOLLOWING 22ND MARCH

So having determined whether your trust falls within the RP regime or not, how will it be taxed for income tax and IHT purposes?

The income tax treatment of an IIP trust is the same regardless of when it was created, in that the IIP beneficiary is entitled to any income arising under the trust and the trustees will be charged to tax at the basic rate (20% for 2022/23) on UK income and 8.75% on UK dividend income. The IIP beneficiary is then entitled to a credit for any tax paid by the trustees on income received by the trust which retains its nature.

This allows the IIP beneficiary to enter the relevant source income in their tax computations, grossed up accordingly with the individual allowed to deduct the tax credit from the total tax due. The IIP beneficiary is able to retain access to their Personal Allowance, Starting Rate Band for Savings Income, the Personal Savings Allowance and Dividend Allowance (where applicable). Any capital gains arising on disposals within the trust are liable to capital gains tax at 20% (28% for residential property gains). The trustees also receive an annual allowance in 2022/23 of £6,150, or £12,300 if the beneficiary is disabled. This annual allowance is then split equally across each trust where more than one trust is established by the same settlor, subject to a minimum of £1,230 in both circumstances.

Contrast this with the income tax treatment of a discretionary trust. Here, income generated by the trust fund, up to the specified amount (normally £1,000 per annum for 2022/23), is chargeable on the trustees at the basic rate (currently 20%), with UK dividend income taxed at the rate of 8.75% for 2022/23. Income in excess of the specified amount is taxed at the rate of 45% (39.35% for UK dividend income).

If the trustees should pay or apply income for a beneficiary's benefit, the trustees should account for 45% tax on any distributed income. The beneficiary will receive any distributed income net of 45% and this figure should then be grossed up and added to the beneficiary's total income. Depending on the beneficiary's overall income position, the whole or part of the tax charged can be reclaimed on their behalf. It should be noted that as this income is always considered non-savings income in the hands of the beneficiary and therefore neither the Personal Savings Allowance, Starting Rate Band for Savings Income nor dividend allowance will be available to offset against it.

The other big difference is with regard to the IHT treatment. A trust that is in the RP regime is subject to entry, ten year periodic and exit charges based on the value of the trust. However, an IIP trust which satisfies the conditions discussed on the previous page will be treated under the old rules. This means that the value of the trust fund supporting the individuals' IIP will be aggregated with their estate for IHT purposes.

COMMENT

While the rules came into force over fifteen years ago we often receive queries on how older trust will be taxed and what options are available for distributions. Trustees need to be very careful in this area and where they are unsure specialist advice should be sought as to the best course of action.

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