

## A TAX ON PRUDENT FAMILIES

### **BRIEFING ON THE FINANCE BILL'S PROVISIONS FOR TAXING TRUSTS**

“The Chancellor's new tax is unfair and imprudent... An ill-thought-out and carelessly rushed provision.” – *The Times (leader column)*, 6 April 2006

“The lack of consultation is gratuitous and offensive.” – *Financial Times (leader column)*, 6 April 2006

“Outrageously retrospective legislative proposals on inheritance tax, wills and trusts” – *Financial Times (leader column)*, 10 April 2006

This document is supported by the following professional bodies:

- The Law Society of England & Wales
- The Chartered Institute of Taxation (CIOT)
- The Society of Trust & Estate Practitioners (STEP)
- The Low Incomes Tax Reform Group (LITRG)
- The Law Society of Scotland
- The Institute of Chartered Accountants of Scotland (ICAS)
- The Association of Chartered Certified Accountants (ACCA)
- The Association of Private Client Investment Managers and Stockbrokers (APCIMS)

#### **1. Summary**

The Government's proposed changes to inheritance tax (IHT) on trusts amount to a tax on prudent families. They will affect millions of ordinary families and not, as the Government has suggested, only the super-rich.

The government has been consulting with professional bodies about the modernisation of trusts for nearly two years. Yet these proposals were never mentioned and came as a complete surprise.

There are also particular problems arising from the fact that the new provisions will operate differently in different parts of the UK because of the different legal jurisdictions, and this alone suggests the need for more time to consult and consider practical implications before any of the proposed changes go ahead.

The key points are as follows:

- Families use trusts for social reasons, not tax avoidance
- Many surviving spouses may suffer hardship by losing their IHT exemption;
- Divorce will become more expensive as inheritance tax may be imposed on assets in trust when a couple divorces;
- Irresponsibility will be encouraged by reducing the age from 25 to 18 at which children must be given capital from a trust or face a penalty;
- Over a million wills will need to be reviewed and rewritten;
- The changes will cost families millions of pounds to make; and

- Vulnerable family members, while not strictly disabled, deserve the protection of trusts from more general disabilities or personal problems.

## **2. Families use trusts for social reasons, not tax avoidance**

The main trusts affected by the Finance Bill are “accumulation and maintenance” (A&M) trusts and “interest in possession” (IIP) trusts. A&M trusts allow families to protect large sums to be given to children at age 25, while IIP trusts provide a flexible income for life, usually for a surviving spouse and children.

Many family wills thus use these for good social reasons, including;

- To protect and provide for the children in the event of the second spouse’s re-marriage;
- To look after a child who is unstable or financially reckless;
- To limit access to money until the children are 25 years old;
- To give assets away to children during the parents’ lifetime but ensure that such assets are kept in trust until the children are financially responsible.

Many people also set up trusts for themselves. This involves no tax saving as such but can help to protect them from their own improvidence in the future. This is of particular relevance in Scotland where people wish to control fully succession to their estate.

## **3. Many surviving spouses may suffer hardship by losing their IHT exemption**

### Pre-Budget

If someone leaves their assets in trust in their will for their spouse, which is very common in second marriages, no inheritance tax is payable until after that spouse (or civil partner) also dies.

### Now

The government is abolishing the spouse exemption except in limited circumstances. A new inheritance tax charge will be payable in many cases where assets are left in trust on the death of the first to die.

For example, if the trustees have any discretion over capital to pay out to the children (often needed in case the surviving spouse remarries), there is inheritance tax payable. Additionally, during the lifetime of the surviving spouse, a further six per cent inheritance tax charge will arise every ten years.

This affects *all* wills where the person has not yet died.

### Why this is wrong

Surviving spouses could find themselves in a very vulnerable financial position if they now have to sell their house to pay inheritance tax.

This could even affect those intestacies in England & Wales where trustees are given statutory discretions to advance capital on continuing trusts for the children.

The change is unfair compared with when a trust is *not* made but assets are left outright between spouses. In this case the only IHT payable is on the second spouse's death.

This leave people in second marriages in an invidious position, as they often don't want to leave all their assets outright to the surviving spouse but equally they don't want to subject the spouse to 40 per cent IHT.

Civil partners who have just remade their wills, leaving their assets in trust for their partner (common in civil partnerships), will have to remake them.

#### **4. Divorce will become more expensive as inheritance tax may be imposed on assets in trust when a couple divorces**

##### Pre-Budget

In a divorce, the house and any assets in trust can be left under a court order on trust for, say, the wife, to be split between the couple years later when the children reach 25. Or existing trusts can be split between spouses so they each take a "life interest". This commonly protects the inheritance of the children from the first marriage should one of the spouses remarry.

##### Now

Such arrangements will now often attract inheritance tax upfront at 20 per cent plus continuing inheritance tax charges at 6 per cent every ten years,

The husband may also be required under court order to settle assets on trust for his children, in which case inheritance tax may be payable immediately at 20 per cent and there would again be further charges every 10 years.

##### Why this is wrong

Inheritance tax will have to be added to the many costs of divorce and children's inheritance will be less well protected.

#### **5. Irresponsibility will be encouraged by reducing the age from 25 to 18 at which children must be given capital from a trust or face a penalty**

##### Pre-Budget

Grandparents typically make a gift into A&M trusts while their grandchild is still an infant.

Until the child is 25, the trustees (usually the grandparents and a solicitor) can retain control over the income and capital. After 25, the income has to be paid to the beneficiary, but trustees can retain control of the capital for up to 80 years.

##### Now

The Finance Bill slaps an "entry" charge on A&M trusts of up to 20 per cent and imposes further charges later.

Where assets are left to them in a will, the age at which children must be given access to money without a financial penalty is reduced from 25 to 18. If the funds are held back after 18, a (a 6 per cent tax charge every ten years) will be payable

This also affects existing trusts already set up, which will need to be changed.

#### Why this wrong

People will either have to pay new charges to make a straight gift of the money when their children are too young. 18 is an unsuitable age for people to inherit and take full control of significant assets in trust. An age threshold of 25 is far more prudent.

- 25 was originally introduced by a Labour government in the 1970s
- It is also the age today at which single people are eligible for tax credits.
- A sudden windfall at 18 is far more likely to be squandered and to fund irresponsible behaviour than at 25. This is especially the case as a growing proportion of 18-25 year olds will be in further or higher education, a policy particularly favoured by this Government.
- Only last month, a study published by the Financial Services Authority showed that young people are not very financially capable and that financial capability clearly improves with age<sup>1</sup>.

### **6. Over a million wills affected**

Based on a post-Budget survey of its members, the Society of Trust and Estate Practitioners (STEP) made a highly conservative estimate that well over a million wills will need to be reviewed and rewritten<sup>2</sup>.

The Treasury claims that only 20,000 trusts created by wealthy families will be affected. But they appear to have taken only trusts registered for tax into consideration, not the million-plus trusts written into wills or trusts that produce no income and so don't have to file a return. Prior consultation might have avoided this confusion.

### **7. The changes will cost families millions of pounds to make**

The Treasury says the change will raise “only” £15 million a year.

STEP estimates that reviewing the simplest wills is likely to cost a minimum of £100 to review but a price tag of £400-£700 may well prove more typical. With at least a million wills needing to be written, this amounts to a charge of between £100 million and £700 million on prudent families.

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<sup>1</sup> “Somewhat ironically, whilst the need to plan ahead is perhaps greatest in early adulthood, financial capability in terms of planning ahead clearly improves with age”: Financial Services Authority, *Levels of Financial Capability in the UK: Results of a baseline survey, March 2006*, page 76. Young people aged 18 to 20 had a factor score of just 27 out of 100, while those aged 20-29 had a higher factor score of 40.

<sup>2</sup> The number of families affected by these changes could run into the millions. In a survey on 31 March, more than 450 STEP members, just over 11 per cent of the membership, said the wills of over 830,000 clients would need to be re-written. Given that nearly 90 per cent of STEP members did not reply and that there are solicitors and will writers who are not members of STEP, this figure is likely to be the tip of the iceberg.

## **8. The way forward**

The professional bodies are proposing the following way forward:

- Implementation of the Government's proposals should be postponed until proper consultation has taken place.
- All trusts for spouses or civil partners whether on lifetime or on death should be exempt from inheritance tax, with inheritance tax only applying after both have died as previously.
- Any trust written into a will should be able to specify that the children (or any other minor beneficiary) receive capital at 25 without a financial penalty, rather than their having to take the money outright at 18, when they can still be relatively immature
- Divorce settlements for spouse should remain exempt from inheritance tax charges, as previously.
- Trusts for settlors themselves should remain exempt from inheritance tax until the death of the settlor, as previously.
- Existing trusts for children should not be taxed adversely, provided that the beneficiaries take their entitlement to income before April 2008 (the stated cut-off date for existing lifetime trusts).
- Particular care should be taken to examine the interests of the vulnerable, who may not be covered by the precise definitions of disability that HMRC are likely to use and thus may be prejudiced by these changes and so subject to additional taxation; the widest reasonable definition should be used based upon the Disability Discrimination Act to protect any exposed individuals here.