

## Chattels Trusts & the Trust Deadline of 6th April 2008

**As we are all aware, the 2006 Budget changed the way in which existing and new trusts are and will be charged to Inheritance Tax (IHT) unless the trust in question is a Discretionary Trust. Generally speaking all lifetime trusts created after 22nd March 2006 will be taxed under the 'Relevant Property' regime that previously applied only to Discretionary Trusts, regardless of the terms of the trust. The creation of a new trust will now trigger IHT at 20% of the value over the nil rate band (currently £300,000) with ongoing charges to IHT on each ten-year anniversary at a maximum rate of 6% of the then trust value. Distributions to beneficiaries between the decades are also charged at a maximum rate of 6% on the value of the distribution.**

Property held in a pre-22nd March 2006 Accumulation & Maintenance (A&M) trust will become Relevant Property on 6th April 2008 (or earlier if a beneficiary acquires a life interest before that date) unless the beneficiaries take absolutely at 18 or between the ages of 18 and 25. In broad terms, property in an Interest in Possession (IIP) trust created before 22nd March 2006 will continue to be taxed on the

death of the life tenant. However, if there is a subsequent IIP, which takes effect after 6th April 2008 the IIP will then be taxed as Relevant Property.

### Relevant Property and Chattels Trusts

If the trustees do nothing, a large proportion of property within pre-22nd March 2006 trusts will inevitably become Relevant Property. This has a particular consequence for chattels trusts as it is unlikely, even with a licence arrangement that covers existing costs, that sufficient income will be produced to pay the ten-yearly or exit charges.

*Here are some ideas that might be of interest while there is still the opportunity to take action.*

### Pre-22nd March 2006 IIP Trusts

The current life tenant might consider giving up his interest before 6th April 2008 when the transitional period ends. Provided the current life tenant can do without the income and the trust provisions allow it, another beneficiary (perhaps a spouse, children or grandchildren) can step into his shoes and be granted a 'transitional serial interest' so that the new rules are deferred until the new beneficiary's death. The release of the original life tenant's interest would be a potentially exempt transfer and provided he survives the requisite seven years, there would be no IHT to pay. There would be no disposal for Capital Gains Tax (CGT) purposes because the assets

remain in trust. If, however, the trustees do nothing before 6th April 2008 any successive life interest will be Relevant Property (apart from an interest granted to the original life tenant's wife on his death).

### Pre-22nd March 2006 A&M Trusts

The trustees may be able to change the trust provisions to avoid the trust becoming Relevant Property on 6th April 2008 and if they do so, there will be no IHT charge when a beneficiary takes at 18 but if they decide to defer winding up the trust until 25 there will be an exit charge (calculated at 0.6% per year for every year the property remains in trust after 18 – giving a maximum charge of 4.2%). The new requirement to take absolutely at 18 or 25 will trigger a CGT disposal although holdover relief will be available. Holdover relief effectively preserves the original base cost and therefore passes on the previous CGT liability to the new owner.

Although chattels trusts are unlikely to produce enough income to cope with the Relevant Property regime intact, trustees may consider the new regime an attractive alternative to absolute vesting. There is always the worry that the rate will increase from 6%.

### Conditional Exemptions

A Conditional Exemption defers capital tax on heritage property while the undertakings accepted by the new owner are

complied with. Pre-22nd March 2006 Conditional Exemptions will remain unaffected by the 2006 Finance Act although the trust property itself will be notionally chargeable under the new tax regime. If no action is taken, pre-22nd March 2006 IIP and A&M trusts with Conditionally Exempt property will eventually either vest absolutely or become Relevant Property. Chattels that do not meet the new pre-eminent test will not be able to benefit from a new Conditional Exemption and will then be subject to IHT. For some this may not be all bad as the onerous post-1998 public access requirements will have no application until the next tax event.

### Business Property Relief (BPR) from IHT

There are alternatives to the Conditional Exemption regime. One such alternative for chattels trusts is to qualify for BPR. BPR can reduce the value of a qualifying business interest by 100% so that there will be no IHT to pay on a taxable event such as the death of the owner. The value of an asset used by a qualifying business can be reduced by 50%.

For BPR to apply the chattels must be part of a business that has been owned by the taxpayer for at least two years before the taxable event and the business must not wholly or mainly deal with investments. Although there are other conditions to be satisfied before this relief is available, it is possible for chattels to form part of a trading business and as such

to qualify for BPR. Owners should be aware that there might be difficulties in getting chattels in to a business for both CGT and IHT reasons and once the chattels are business assets, VAT can apply on a subsequent sale.

## **PROPOSED CHANGES TO GAINS TAX**

The 2007 Pre-Budget report proposes among other things a sweeping change to the nature of the Capital Gains Tax ('CGT') charge on disposals made after 6th April 2008. Under the current rules, an indexation allowance is applied to the base cost, the cost of acquisition, to alleviate the effect of inflation on ownership from 1982 to 1998. Taper relief is then applied to non-business assets to reduce any remaining gain on a sliding rate based on the number of years of ownership from 1998 so that a maximum of 60% of the remaining gain is taxable. CGT is then charged at a maximum rate of 40% on the remaining gain.

The Pre-Budget report proposes to abolish the indexation allowance and taper relief for individuals, personal representatives and trustees and replace the current rates of CGT with a flat rate of 18%. Companies will remain on the previous CGT regime. While this may seem attractive, the loss of the indexation allowance from 1982 and taper relief for non-business assets will mean that owners whose base cost exceeds approximately one quarter of their disposal price will be worse off under the proposed new CGT rules.

Owners of business assets currently enjoy taper relief after two years of post-1998 ownership so that only 25% of any gain is chargeable to CGT, leaving an effective rate of CGT of 10%. Disposals of business assets after 6th April 2008 will be significantly more expensive than under the existing regime.

*The above should not be relied upon as advice and owners should seek professional advice before taking or not taking a course of action.*