

A flexible friend

CHRISTIAN WARD looks at the attractions of flexible reversionary trusts for estate planning.

Discounted gift trusts (DGTs) and loan trusts remain the most popular method to mitigate inheritance tax, while retaining some form of access to an income or capital. Practitioners are often divided on the use and suitability of these schemes. This article highlights an alternative planning structure: the flexible reversionary trust (FRT). I use the generic term flexible reversionary trust, as the terms 'trust carve out' or 'reverter to settlor' do not adequately differentiate the unique nature of the planning. The relative obscurity of FRTs may be explained by their description as reverter to settlor trusts, which are therefore presumed to have been rendered ineffective post Finance Act 2006. This is not the case.

How a FRT works

There is only a very small number of providers who offer a FRT, and yet there are a number of differences from plan to plan. The traditional form is as follows:

- The settlor invests in a series of single premium endowment life assurance policies, each with a specified term usually ranging sequentially from one to ten years.
- Each policy has a number of equitable rights: the death benefit, surrender benefit, maturity benefit and extension option.
- The settlor gifts all these rights, apart from the right to the maturity benefit, into an interest in possession or discretionary trust. The settlor and spouse are excluded from benefiting from the trust.
- On maturity of each policy, the proceeds will revert to the settlor.
- The flexibility comes through the wide powers vested in the trustees.

KEY POINTS

- Mechanics of a flexible reversionary trust.
- Flexible investment features.
- Importance of using independent professional trustees, rather than settlors.
- Effect of pre-owned assets tax on FRTs.



- The trustees can partially or fully defeat the settlor's interest in a policy before the maturity date. Capital can therefore be appointed to beneficiaries at any stage.
- The trustees can also exercise the maturity extension option and postpone the maturity of a policy to a future date.
- As the trustees can defeat the settlor's rights to the maturity benefit, the value of the settlor's retained rights is effectively nil. Therefore the initial transfer of value is the full value of the initial investment into the series of endowment policies. For the same reason the postponement of any policy maturity is not a further transfer of value. This factor is of critical importance to the efficacy of the FRT.
- The gift into trust will be a chargeable lifetime transfer and effectively limits the initial gift to the settlor's remaining nil rate band, a maximum of £312,000 (2008-09).
- In the normal course of events, the trustees are likely to postpone the maturity of each policy. After seven years, although the full amount of the initial gift would fall outside the settlor's estate, he would still retain potential access to the full value of all policies.

Let us compare and evaluate the FRT against the alternative options of a DGT and loan trust.

No automatic income

A paradox of a DGT is that although the discounted value of the initial transfer falls outside the settlor's estate after seven years, the annual payments to the settlor will accumulate in his estate unless spent. For many people an immediate and continuing income is not required, and is only taken because there is no option not to. A loan trust achieves little inheritance tax saving until the loan starts to be repaid.

The FRT allows the trustees to extend a policy before it matures, ensuring the settlor does not receive unnecessary capital payments.

Not restricted to a fixed income

A major disadvantage with DGTs is that access to capital is lost and the income level is set in stone at outset. Few people would choose an investment with such a restriction under normal circumstances. This can be seen by the general antipathy to annuities, where a capital sum is exchanged for a set income for life.

A DGT involves a similar concept, but at least any capital remaining on death is available to the trust beneficiaries. However, a rigid income does present long-term planning issues. An income set at 5% of the initial fund value will fall by 45% in real terms with an inflation rate of 4% a year over 15 years. Why commit to a fixed income when you don't have to?

A FRT allows the settlor to structure policy maturities in line with their expected future expenditure needs. Furthermore, each maturing policy will include all investment growth and so an element of inflation protection is in-built. A loan trust technically allows the settlor to reclaim the entire outstanding loan amount at any time, although he cannot benefit from any investment growth.

Power of deferral

The extension of any policy by the trustees will not be a further transfer of value by the settlor, as the settlor's retained rights are effectively valueless. Any potential argument that there is a transfer of value by associated operations should be ruled out following the decision in *Rysaffe Trustee Co (CI) Ltd v CIR* [2003] STC 536. Post FA 2006, HMRC have confirmed that a policy extension is not a further chargeable lifetime transfer.

The inheritance tax neutrality of policy deferrals provides the mechanism for the FRT's efficacy. This combination of inheritance tax efficacy and adaptability is simply not available with either DGTs or loan trusts.

How important is a discount?

In contrast to a DGT, no discount will be applied to the amount gifted into trust. However, for clients with life expectancies exceeding seven years, a discount is really of negligible value, as after seven years the full value of the initial transfer would be exempt. It is possible to use the reversionary structure and gain a discount, but the trade-off is that the policies cannot be extended and capital cannot be appointed to beneficiaries until after the settlor's death.

Appointing capital

The trustees' powers allow trust capital to be appointed outright to beneficiaries or upon new trusts during or after the settlor's life. Post FA 2006, the appointment of capital to beneficiaries from a FRT has no inheritance tax implications, other than being taken into account in the normal manner for periodic and exit charge calculations. Appointing capital to beneficiaries from a DGT is more problematic, and in many cases impossible during the settlor's lifetime. Although

EXAMPLE 1

Mr and Mrs Buller are both retired in their early 60s with pension incomes which currently cover their expenditure needs. They have savings and investments totalling £700,000 and property worth £800,000 with no debts. They have two self-sufficient children and one young grandchild. At this stage they are uncomfortable with making outright gifts but they may consider this at a later stage.

They decide to settle £250,000 each on interest in possession trusts. They each establish two separate trusts for £100,000 and £150,000 to maximise the headroom for future investment growth before periodic and exit charges will be applicable. Each trust is settled on separate days with different children as the life tenant. The Bullers transfer existing unit trust holdings into trust rather than invest in new units. As the FRT is deemed to be settlor interested, capital gains tax holdover relief will not be available, but the recent stock market falls mean that there is no gain on the deemed disposal. The transfers are chargeable lifetime transfers but there is no immediate tax charge as the amounts are within the nil rate band.

The Bullers each carve out the right to receive 10% of the settled units each year as a 'reversion' for ten years. They appoint a corporate trustee to administer the trusts and draft letters of wishes. In keeping with the Bullers' wishes, the trustees defer the reversions each year for a further ten years. After ten years the four trusts have increased in value from £500,000 to £934,000, equivalent to 7% growth a year. No periodic charge will be due based upon these figures. The Bullers could still receive reversions of 10% each year, equivalent to £93,400 plus any further investment growth. The full value of each trust would not form part of the Bullers' estates after the first seven years. As their financial situation has not deteriorated they inform the trustees that they would like the trust funds to be used to meet the school fees of their grandchildren.

What have the Bullers achieved? They created a flexible structure that allowed them to remove £500,000 from their estate, while retaining potential access to this amount plus the future investment growth. The depressed asset values ensured no capital gains tax was due on the transfers into trust and future investment growth would be outside their estates from day one.

the settlor of a loan trust could gift part of his entitlement to a loan repayment, this would be a further transfer of value.

Investment holding structure

Discounted gift trusts and loan trusts have traditionally been provided by insurance companies. However, the life assurance bond structure, whether onshore or offshore, is not always the most suitable option. One reversionary trust provider allows the trust to be established with either life assurance bonds or unit

trusts/open-ended investment companies. Unit trusts do not 'mature' but the reversionary concept is just as applicable.

The use of unit trusts can be particularly attractive for long-term growth investments with the reduced CGT rate of 18%, compared to a maximum potential tax charge of 40% for offshore life bonds. Having a choice of investment holding structure ensures the trustees can tailor the investments to the unique requirements of the settlor and expected beneficiaries, whilst retaining the flexibility to adapt to changes in future legislation and trust objectives.

Gift with reservation

The retention by the settlor of a reversionary interest is a well established concept and will not be treated as a gift with reservation of benefit, as long as the retained rights are clearly defined and separate from the gifted rights. This is the carve-out principle as endorsed by the House of Lords in *Ingram & Palmer-Tomkinson (Lady Ingram's Executors) v CIR* [2000] STC 37. HMRC have long accepted that the retention by the settlor of a reversionary interest does not constitute a gift with reservation of benefit (see Inland Revenue letter 'IHT: gifts with reservation' to the Law Society of 18 May 1987).

“ The flexibility of the FRT cannot be overemphasised. ”

The settlor and spouse are excluded beneficiaries under the trust, although a widow/widower can benefit. Although the settlor or spouse cannot benefit from the exercise of the trustees' powers, he will benefit if the trustees do not exercise their powers to defeat or defer the reversions to the settlor. Could HMRC argue that there is a reservation of benefit by associated operations due to the trustees' omission to defeat the settlor's interest? This seems unlikely as the trustees' powers are detrimental and not beneficial to the settlor. However, it is important that the trustees' fiduciary duty is not compromised by treating the trust as a mechanism to provide benefits to the settlor at his request. For this reason it is preferable that independent professional trustees are appointed and the settlor and spouse do not act as trustees.

Pre-owned assets

HMRC guidance and practice are particularly important in relation to pre-owned assets tax. Packaged insurance schemes such as DGTs have been the subject of considerable scrutiny since FA 2004. As with DGTs, HMRC have confirmed that the settlor's rights within an FRT are deemed to be held on bare trust for the settlor. As the settlor is excluded from benefiting from the gifted property held in the settlement, pre-owned assets tax cannot be in point.

The department's view on DGTs and FRTs is not universally held. Few practitioners would argue that the legislation is clear, but the very fact that HMRC have taken such an emphatic stance

with these schemes has moved many practitioners to a position of begrudging acceptance.

Finance Act 2006

Prior to FA 2006, FRTs were invariably interest in possession trusts. Any reversions to the settlor during the life tenant's lifetime benefited from the reverter to settlor relief exemption in IHTA 1984, s 53(3). This is no longer applicable. Since FA 2006, HMRC have confirmed that they regard the settlor's reversionary interest as being held on bare trust for the settlor, and therefore not relevant property within the meaning of IHTA 1984, Part 3 Chapter 3. This ensures that reversions to the settlor will not attract exit charges or be valued for the purposes of the periodic charge.

HMRC have effectively extended the carve-out concept established under reservation of benefit to both pre-owned assets tax and treatment under the relevant property regime. This creates a very favourable environment for trusts such as the FRT and DGT, and one which some commentators struggle to reconcile with a strict interpretation of the relevant legislation.

Conclusion

The flexibility of the flexible reversionary trust cannot be overemphasised and makes this structure particularly attractive for clients who require the inheritance tax savings, control and flexibility of a standard discretionary trust, but who also wish to retain potential access to the gifted capital. No other solution offers this unique combination of features.

Current economic conditions are only likely to exacerbate the tendency to delay making lifetime gifts. The FRT can facilitate lifetime planning while providing a flexible structure to transfer wealth to family members both during and after the settlor's life. It is more effective for inheritance tax purposes than a loan trust and less restrictive than a DGT.

If a client wishes to retain an indefeasible right to the gifted capital or income, then a DGT or loan trust might be preferable. No solution allows a client to truly have his cake and eat it. The potential risk that the trustees will defeat reversions against the settlor's will is the quid pro quo of the flexibility of the FRT.

The introduction of pre-owned assets tax demonstrated the risks of undertaking tax planning deemed to be unacceptable by Government and HMRC. The FRT structure has been used for nearly 20 years and survived the major legislative changes intact. HMRC have had ample opportunity to scrutinise the planning over this time. FRTs were bought within the relevant property regime by FA 2006 and thus the scope to save inheritance tax was severely curtailed, as clients are now effectively limited to transfers under the nil rate band.

The clear and emphatic opinion provided by HMRC on FRTs and DGTs can surely provide considerable reassurance that these types of schemes are not deemed to be unacceptable tax avoidance. ■

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