canada life

International

Wealth Preservation Trust

The variable inheritance tax plan

Tax Notes

Note: All references are to Acts of the UK Parliament

Background

The Wealth Preservation Trust (WPT) is available through either the Wealth Preservation Account (Isle of Man) or the Wealth Preservation Europe Account (Ireland).

The WPT is available on a single settlor only basis. Joint settlors cannot effect a WPT due to the legal ownership on death automatically passing to the surviving settlor. This would mean that, without a great deal more complication, the exemption under the pre-owned assets tax legislation would be lost.

The settlor applies for a series of specific term single premium life policies. Each policy will confer a death benefit, surrender benefit and a maturity benefit. Once the policies have been issued, the settlor immediately assigns the legal title of the policies to the trustees of a bare trust (the 'Initial Trust') under which the settlor is the absolute beneficiary. The following day, the settlor assigns his beneficial interest in the policies to the trustees of a settlement (the 'Settlement').

The Settlement is a discretionary trust where the Settlement trustees may distribute the trust fund to any beneficiary (whether named individually or as a member of a class), as they in their complete discretion see fit. If the policies are allowed to mature, the settlor is the beneficiary by way of a reversionary interest.

The legal title rests with the Initial trustees but all decisions are made by the Settlement trustees. The Settlement trustees can decide to surrender or extend the maturity of any of the policies and then instruct the Initial trustees to carry out the request.

Inheritance tax considerations

1. The Initial Trust is not a settlement for inheritance tax (IHT) purposes [s43 IHTA 1984].

2. Subject to any available exemptions, the gift of the beneficial interest in the policies to the Settlement is a chargeable lifetime transfer (CLT) for IHT purposes.

   The amount of the CLT is equal to the premium paid less any available exemptions.

   Any transfers made by a settlor in any one tax year are exempt if they do not exceed £3,000 [s19(1), IHTA 1984].

   In addition, any transfer is exempt to the extent that:
   - it was part of the normal expenditure of the settlor, and
   - it was made out of his net income, and
   - the settlor was left with sufficient income to maintain his usual standard of living [s21(1), IHTA 1984].

3. If the amount of the current transfer (after exemptions) and the total of all CLTs made by the settlor within the previous seven years (the settlor's cumulative total) exceeds the current nil rate band (currently £325,000), IHT will be payable on the excess at the lifetime rate.

   The lifetime rate is half the standard rate of IHT [s7(2) IHTA 1984] and is 20% currently.

4. The exercise of the right to defer the maturity date or surrender a policy will not give rise to a transfer of value by the settlor.

5. The value of the settlor's reversionary interest should at all times be nominal, given the ability to defeat this interest at any time.

Gifts with reservation

6. Although the settlor retains a reversionary interest under the Settlement, this is entirely separate and distinguishable from the interests of the beneficiaries. A benefit is payable either to the settlor or to the beneficiaries, but not to both. Therefore, the respective benefits do not vary by reference to each other.

   Accordingly, the transfer does not constitute a gift with reservation failing within s102 or Schedule 20 of Finance Act 1986.

7. It is important that the settlor does not receive any benefit from distributions received by the beneficiaries. If the settlor did receive a benefit, HM Revenue & Customs (HMRC) could argue that there was a gift with reservation. This is particularly relevant if the settlor's spouse or civil partner is a beneficiary and they receive a distribution.

8. It is also accepted by HMRC that the retention of a reversionary interest under a trust is not considered to be a reservation of benefit. Indeed, HMRC accept that the retention of a reversionary interest in a settlement does not jeopardise the IHT effectiveness of insurance-based IHT mitigation arrangements like the WPT.

Periodic Charge

9. A potential charge to IHT will arise on every tenth anniversary of the creation of the Settlement [s64, IHTA 1984].

   In order to calculate any tax that may be due, it is assumed that a chargeable transfer has been made on the tenth anniversary [s66(3), IHTA 1984].

   The basic principle is that you aggregate the value of the settled property at each ten-year anniversary, plus any amounts distributed or appointed to the beneficiaries in the previous ten years, plus the value of any CLTs made by the settlor at any time in the seven-year period before creating the Settlement. If this is less than the available nil rate band at the ten-year anniversary no IHT will be charged.

   If there is an excess, the rate of tax on the excess is 30% of the lifetime rate of IHT (20%) [s66(1) IHTA 1984] and is therefore 6% currently.

   It should be borne in mind that potentially exempt transfers (PETs) made in the seven years before the Settlement is established can impact on the calculation of the ten-year charge, if the settlor dies causing the PETs to fail.

   HMRC have confirmed that the maturity proceeds of each policy that have been paid to the settlor are not included in the calculation of each ten-year charge, unless they are paid on the ten-yearly anniversary itself.

Exit Charge

10. Where a policy is appointed to or capital is paid out of the Settlement to a beneficiary (for example a policy is surrendered and the proceeds paid to a beneficiary) a charge to IHT, in the form of an exit charge, may arise.

    HMRC have confirmed that no exit charge will arise when a policy matures during the settlor's lifetime.

    ### Exit charges in the first ten years

    If IHT was payable when the Settlement was created, exit charges will apply in the first ten years. If there was no IHT payable on creation, there will be no IHT exit charges on any appointments or distributions of capital to the beneficiaries in the first ten years.

    Any exit charge due in the first ten years of a settlement is based on the value of the assets settled into the Settlement when they were gifted.

    ### Exit charges after the first ten years

    Once the trust has passed its first ten-year anniversary, IHT exit charges are always based on the effective rate of tax used for the previous ten-year anniversary charge. If this was zero, there will be no IHT exit charges on any appointments or distributions of capital to the beneficiaries in the following ten years.

    For the calculation, you must establish the effective rate of tax applying to the trust at outset or at the ten-year anniversary. The charge to IHT is calculated by reference to the "appropriate fraction" of the effective rate at which IHT would be charged on the hypothetical chargeable transfer of value. In short, the "appropriate fraction" is the number of complete quarters since the Settlement commenced, divided by 40.

Reporting

11. When the settlor creates the Settlement, if the value of the CLT, plus all CLTs in the last seven years, exceeds 80% of the nil rate band, they will need to inform HMRC using the forms IHT100, IHT100a, D34 and D39 within 12 months.

    At each ten-year anniversary of the Settlement, if the relevant value calculated in accordance with section 10 above exceeds 80% of the nil rate band, forms IHT100 and IHT100d will need to be submitted to HMRC, by the trustees, within six months.

Income tax considerations

12. Persons who are UK resident are taxed under the "chargeable events" legislation contained in Chapter 9 Part 4 Income Tax (Trading and Other Income) Act 2005 (ITTOIA).

    The initial assignment of the policies into the Settlement is not 'for money or money's worth' and is thus not a chargeable event for tax purposes [s484(1) ITTOIA).

    If benefits are payable on maturity, surrender or death, a chargeable event may occur. With the exception of adviser charge payments, there is no partial surrender right in the policies. The payment of adviser charges for investment advice and services supplied to the Settlement trustees will be treated as a partial surrender and will form part of the 5% tax-deferred allowance.

    As the policy is held under trust, any tax charge is a liability of the settlor [s465(3) ITTOIA]. The settlor has a right of indemnity against the Settlement trustees for the income tax paid [s538 ITTOIA].

    If the settlor is 'absent' because they are non-UK resident or they have died in a previous tax year, any tax charge is a liability of the trustees, provided that the trustees are UK resident [s467(1) ITTOIA].

    If the trustees are not UK resident, any individual who is UK resident and benefits from the proceeds would be assessed to tax on the chargeable gain [s468(1) ITTOIA].

    If the Settlement trustees appoint a policy absolutely to a beneficiary, any gain arising from that policy will be assessed on the beneficiary unless the parental settlement rules apply.

Pre-owned assets tax (POAT)

13. WPT works within the POAT legislation to give the settlor exemption from income tax on pre-owned assets.

    The use of two trusts – the Initial Trust and the Settlement – enables the settlor to identify, in equity, the property in which his reversionary interest subsists. That property is the right in equity to the maturity benefit payable under each policy. The maturity benefit under each policy is relevant property for the purposes of POAT. The reversionary interest is property which derives its value from this relevant property. The value of the reversionary interest will be the same as the open market value of the maturity benefits. The reversionary interest should therefore be exempt from the charge to tax under paragraph 11(1)(b) Schedule 15 Finance Act 2004.

    Even if it could be argued that the exemption did not apply, HMRC have said in the Inheritance Tax Manual (at IHTM44112) that:

    "Where, however, the POAT charge does arise, it will be by reference to the value of the rights held on trust for the settlor, not by reference to the value of the underlying life policy. An open market value of those rights will need to be obtained in order to calculate the charge."

    The rights held on trust for the settlor are the rights to each maturity benefit. The value of those rights is nominal, as the Settlement trustees are able to defeat the maturity of a policy.

General Anti-Abuse Rule

14. The General Anti-Abuse Rule (the 'GAAR'), introduced in Finance Act 2013, is targeted at abusive tax avoidance schemes. It enables HMRC to counteract abusive tax avoidance schemes by a tax adjustment which is just and reasonable in all the circumstances. HMRC have published Guidance, which has been approved by the GAAR Advisory Panel. That Guidance contains examples of abusive and non-abusive arrangements. Part D, paragraph 27, of the Guidance contains a section on 'discounted gift schemes and the scope of reservation of benefit'.

    Whilst the WPT does not generate a discount for IHT purposes, it is nevertheless similar in design to a number of discounted gift schemes.

    Leading Counsel has advised that the WPT should fall within the scope of paragraph 27 and, as such, it should not be regarded as being within the scope of the GAAR. In addition, and in any event, Leading Counsel has advised that the WPT should not be regarded as an 'abusive' arrangement. Leading Counsel did not consider that the role of the settlor as a trustee of the Settlement, or not, was relevant to the GAAR analysis.

Disclosure of Tax Avoidance Schemes (DOTAS)

15. The new guidance on DOTAS gives assurance that using the WPT is acceptable estate planning (IHTM20562).

This document is based on our understanding of applicable legislation, law and current HMRC practice as at May 2020. It is provided solely for general consideration. We suggest that you seek your own independent tax advice.

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