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The state of disabled trusts

Lynne Bradey reviews the changes made to disabled trusts following amendments to the Inheritance Tax Act 1984.

Trusts for the disabled arise under s89 et al of the *Inheritance Tax Act 1984* (ITA 1984) and have undergone some important changes recently. The definition of a 'disabled person' has changed, and a capital gains tax free uplift has been introduced for discretionary s89 trusts, which would apply in the same way as for life interest s89 trusts.

Trusts are widely used to protect assets, and their use is particularly important when beneficiaries are suffering from a disability or are otherwise vulnerable. For example, when a person's chosen beneficiary is in receipt of means-tested benefits, a trust needs to be set up for the beneficiary before the testator's death. Unfortunately, this is not done in the majority of cases: for every person who gets in touch knowing that a relative is going to leave them money and seeking advice about the most effective way to achieve this, there are at least nine people in receipt of means-tested benefits who have found out too late that they are to receive an inheritance outright and do not have a proper structure in place.

Often the sums of money are not particularly large and, if benefits are lost, will not give any real advantage to the person receiving the inheritance, other than a short break from benefits and a lot of forms to fill in further down the line. Fair enough, you might say – at least they are no worse off. However, in some cases, the client might well be worse off if they inherit because the testator did not put in place an appropriate trust.

When an appropriate trust is not in place

Some people are terrified the support they have been receiving to get their life back on track after a period of severe mental illness, homelessness, addiction, or a combination of the three will be withdrawn because they believe it is only available to people in receipt of benefits. They do not mind paying for the support, but they feel they might be disqualified altogether from the one thing that has offered them some light at the end of the tunnel. The local authority should not withdraw support just because a person has funds, but the law and practice are sometimes very far apart and, when a person is seen as a self-funder, under-resourced local authorities sometimes try to wash their hands of them.

Other people, who receive care services from the local authority, might find that the amount of care they receive is reduced on a permanent basis.[1] If, as a result of an inheritance, they cease to qualify for care services provided by the local authority, it may not simply be a case of plugging back in when their capital falls below the relevant limit. In these cash-strapped times, local authorities are restricting the level of needs that they are willing to meet. Somebody who has been receiving a care package from the local authority for a number of years may well be able to continue to receive that care package, even if the level of need is below that which the local authority would seek to fund nowadays. However, a new applicant could have a much harder time establishing that the provision they had two years ago is something the local authority should meet now.

Since the upper capital limit for means-tested benefits, above which a claimant has no entitlement, is GBP16,000 for a claimant or couple, and the individual upper capital limit for care is GBP23,250, even reasonably modest inheritances can cause problems.

Some people are not particularly concerned about means testing, but have other reasons for wanting to leave funds to their chosen beneficiary in a trust. Their relative may suffer from a condition, such as bipolar disorder, that could render them liable to spend excessively at certain stages of the condition; have current or previous addiction issues; be vulnerable to pressure from less-than-well-meaning associates or family members; or might just not be good with money.

Types of trusts

Where the amount of money involved does not exceed the nilrate band, a straightforward discretionary trust might well fit the bill. Where the amount of money in a trust is likely to exceed the nilrate band, however, the eligibility of both the trust and the intended beneficiary under s89 can be very valuable indeed. If more than the nilrate band is left to a 'normal' discretionary trust, inheritance tax will be charged at the rate of 20 per cent on the amount above the nilrate band and there will also be ten-year and exit charges. These charges will not apply if the trust qualifies as an s89 trust.

Who is a disabled beneficiary?

A 'disabled person' is defined as a person who is:[2]

- by reason of mental disorder within the meaning of the *Mental Health Act 1983*, incapable of administering their property or managing their affairs;
- in receipt of attendance allowance;
- in receipt of a disability living allowance by virtue of entitlement to the care component at the highest or middle rate;
- in receipt of personal independence payment by virtue of entitlement to the daily living component;
- in receipt of an increased disablement pension;
- in receipt of constant attendance allowance; or
- in receipt of armed forces independence payment.

There are also provisions to ensure that, if a person would have qualified for one of the above benefits but for their residence in a hospital or care setting, they would still be able to qualify under s89.[3] In addition, from 6 April 2014, people who are in receipt of the mobility component of disability living allowance at the higher rate or the mobility component of personal independence payment at the standard or enhanced rate will also qualify.

The most common method of qualifying is to be in receipt of disability living allowance for care. Disability living allowance is currently being replaced by personal independence payment for everyone

of working age, and so this will likely become the primary method of qualification.

It is worth noting that some people who might benefit from a s89 trust are not included in this definition of ‘disabled’. Having a medical condition that is not within the *Mental Health Act 1983* definition of ‘disabled’ or does not lead to the person receiving one of the listed benefits above means that the person is not entitled to s89 status. Being otherwise vulnerable – for example, by reference to a history of addiction or violence – is also insufficient to qualify for s89 status.

The definition of a ‘disabled person’ has been the subject of ongoing consultation between the profession and HM Revenue & Customs (HMRC). Some significant progress has been made and HMRC has indicated it will continue to look at the criteria for qualifying under s89.

Which type of trust qualifies?

Discretionary and life interest trusts qualify. Under the original s89 of the ITA 1984 there was only one type of trust: a discretionary trust. The *Finance Act 2006* then introduced s89A into ITA 1984, which allowed for self-settlement, and s89B, which brought in the option of a life interest version of a disabled trust. Discretionary and life interest trusts can either be set up by the disabled person themselves or by somebody else. In the case of a discretionary trust, there needs to be a named disabled beneficiary and there are restrictions on funds that can be paid for the benefit of anybody else. In the case of a life interest trust, the life tenant needs to be the disabled person. Where the trust is self-settled, a person can establish a valid s89 trust if they can persuade HMRC that they have a condition that it is reasonable to expect will bring them within s89 status later on. For example, a person may have multiple sclerosis, in which case it is reasonable to assume that this will lead to them being able to claim disability living allowance further down the line. That option is only available for self-settlement, and not for trusts established by anybody else.

The rules on payments out of these trusts used to be quite wide but, with the bringing into line of vulnerable beneficiary status for income tax, capital gains tax and inheritance tax, the powers of trustees to make distributions to people other than the disabled person have been greatly restricted. In the case of a discretionary trust, the position used to be that, as long as one-half of the capital that was paid out was for the benefit of the disabled person, the trust could continue to qualify. Under the new rules,[4] from 17 July 2013, only 3 per cent of the trust fund or GBP3,000 in any given year, whichever is the lower, may be paid out for the benefit of somebody else. With life interest trusts, the previous wide position relating to capital has been replaced with the same restrictions. On the positive side, the law has now been changed to allow discretionary-type s89 trusts to benefit from the capital gains tax free uplift on death in the same way as life interest trusts. This has been an anomaly for a number of years and the correction is greatly welcomed.

For trusts in place before 8 April 2013, the old rules will apply.[5] Trusts arising under wills that were executed before that date but that are replicated in a later will or republished by a codicil can also continue to benefit from the old rules. Great care must be taken in advising clients with these types of

trusts in their wills when they want to make changes, as anything other than a direct replication will probably fall foul.

The future

HMRC has said it will continue to consult with the profession about the definition of 'disabled person'. As the restrictions on the amount of money that can be paid out of a trust for the benefit of somebody other than a disabled person under the inheritance tax legislation are now in line with those for the other taxes, extending the definition of a disabled person further is likely to be the next issue for discussion. There is still a substantial group of people who would receive no inheritance tax benefit from their funds being held within a trust rather than by them personally, but who could receive an extremely large social benefit if they fell within the definition.

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1. *1 Information on the provision of care is drawn from the author's experience of working with local authorities in England*
2. *2Paragraph 1, Schedule 1A Finance Act 2005*
3. *3Paragraphs 2, 3, 4, 5, 6 and 7 of Schedule 1A Finance Act 2005*
4. *4Amendments were made to ITA 1984 by s216 Finance Act 2013 (FA 2013), which refers to paragraphs 1 and 10 of Schedule 44*
5. *5Section 89C ITA 1984, prior to amendment by s216 FA 2013 and paragraphs 1 and 10 of Schedule 44*

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