

Inheritance Tax – Ongoing Tax Treatment of Trusts

Overview

Discretionary trusts are assessed for IHT on their tenth anniversary and every 10 years after that. Distributions from the trust may also trigger an IHT charge. These rules apply to trusts created during the settlor's lifetime and those created within the settlor's will.

Since 22 March 2006, the same treatment will apply to funds gifted into most interest in possession (IIP) and accumulation and maintenance (A&M) trusts. Fuller details on the trusts affected by these changes can be found in a separate factsheet: Inheritance Tax – Chargeable Lifetime Transfers.

This factsheet aims to provide financial advisers with a basic understanding of these taxation rules. This can be a very complex area and will often require a professional adviser to perform the necessary calculations.

All content assumes a UK resident trust and a UK domiciled, resident or ordinarily resident settlor. It is also assumed that the trust is one where neither the settlor nor his spouse, during the settlor's lifetime, can personally benefit from it. Any stated rates of tax are for the tax year 2009/10.

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Important information

Relevant property

'Relevant property' is the term used to describe trust property where there is no 'qualifying interest in possession'. This used to mainly cover discretionary trust assets, other than those that were specifically exempted from an IHT charge (for example charitable trusts and pension trusts) or where the assets held within the trust were themselves exempt (for example under business property relief).

Since 22 March 2006, many IIP and A&M trusts are treated as not having a qualifying interest in possession and therefore assets held by such trusts will be classed as relevant property and taxed in exactly the same way as discretionary trusts. See Inheritance Tax – Chargeable Lifetime Transfers Factsheet for details of the trusts affected.

For the purposes of this factsheet, the term 'relevant property trust' means any discretionary, IIP and A&M trust that holds relevant property.

The 10-Yearly 'Periodic' Charge

The first periodic review is due on the tenth anniversary of the commencement of the trust. The commencement date will be the date on which property was first added to the trust. For trusts created within a will, or by a post-death deed of variation, the commencement date is the date of the settlor's death.

Example 1

Bill created a discretionary trust with a nominal gift of £10 on 5 March 1998. The trust was designed to receive further funds on his death, as part of an IHT planning exercise. Bill died on 19 September 2007 and under the terms of his will £250,000 was settled into the discretionary trust. The first 10-year charge was due on 5 March 2008.

Switching property between trusts

It is not possible to transfer trust property from one trust to another in the hope of avoiding a 10-year charge on the original trust. The rules state that for the purposes of IHT the property would still be deemed as remaining in the first trust and therefore the commencement date of that trust would be used for this purpose.

This rule can also have an impact upon 'bypass' trusts used in pension planning where the settlor's pension scheme is itself constituted under a discretionary

trust. Bypass trusts are created by an individual to accommodate any payment of a pension scheme lump sum death benefit. If the settlor were to die and the pension scheme paid out a death benefit, into the bypass trust, then this would be a transfer from one trust to another. HM Revenue and Customs (HMRC) treat the commencement date as being the date that the individual joined the scheme and it is that date that should be used to determine the 10-yearly anniversaries under the bypass trust. This could lead to a 10-year review falling shortly after the discretionary trust receives the death benefit from the pension scheme trustees. There could be an IHT bill as a result of the review. Note that there may be scope to defer a death benefit payment into a bypass trust (such payments can be made from a pension scheme, free of IHT, in the two years following the member's death) until after the next 10-year review.

Related trusts

Should a settlor create a relevant property trust and, on the same day, any other trust then these are 'related' trusts. The initial value of any property within related trusts is totalled for the purposes of the 10-yearly and proportionate charges. It is therefore prudent, as a general rule, to avoid creating multiple trusts that would be treated as related.

An established method of tax planning is to create a number of separate trusts on different days. The combined value of gifts into these trusts is kept below the nil rate band. Each individual trust would therefore be assessed on its 10-year anniversary, against the nil rate band then current. This maximises the potential to avoid an IHT charge on the review. If the trusts are identical in nature, HMRC may seek to treat the group of trusts as one for the purposes of the 10-year charge, under their anti-avoidance powers. That said, in the case of *Rysaffe Trustee Co (CI) Ltd v CIR* (2003), the Court of Appeal found in favour of the taxpayer, who had created five identical discretionary trusts within a 35 day period, dismissing HMRC's contention that they were associated operations and should be treated as one. However, it is still prudent, wherever possible, for the separate trusts to have different terms or definitions. This is a specialist area and expert advice should be sought before proceeding with arrangements of this nature.

If a number of trusts are created by a will then they may be treated as being related as all will have the same commencement date (the date of the settlor's death). There is an exemption for charitable trusts that are not temporary in nature. There are also special rules which exclude any funds held within a related settlement that is in favour of a deceased settlor's surviving spouse or civil partner, provided it is either an immediate post-death interest or a disabled interest.

Any other combination of a relevant property trust and another trust, such as an A&M trust or an IIP trust for a common law partner or children, will be related and their property values added together for a 10-year charge assessment.

Calculating the charge

The IHT calculation at a 10-year review can be extremely complicated and it is only possible, in a document of this nature, to provide the key points and some relatively straightforward examples.

For the purposes of the 10-year charge calculation it is assumed that the trustees make a chargeable transfer of the relevant property in the trust which is taxable at the 20% lifetime rate of IHT. This taxable amount is then expressed as a percentage of the value of the 'deemed chargeable transfer' to calculate an 'effective' rate of tax. The 10-yearly rate is 30% of the effective rate and is charged on the whole amount of the deemed chargeable transfer. Note that the 10-yearly rate can never exceed 6% (which is 30% of 20%).

Deemed chargeable transfer

the first step is to assume that the trustees are making a chargeable lifetime transfer equal to:

- the market value, immediately before the 10-year anniversary, of all relevant property in the trust, plus
- the value of any property, immediately after the trust commenced, in related trusts, plus
- the value of any non-relevant property within the trust, immediately after the trust commenced, provided that property was never relevant whilst in the trust, plus
- the value of any non-relevant property added after the trust commenced but before the periodic charge.

Example 2

Jim died on 16 June 1996. In his will he passed his holiday cottage, then valued at £100,000, into a discretionary will trust and also settled a portfolio of shares valued at £50,000 into an A&M trust for his grandchildren.

The market value of the holiday cottage on 16 June 2006 was £400,000 and this remained the only asset within that trust. The trustees are therefore deemed to have made a chargeable transfer valued at £450,000 on this date, which is the then current value of the discretionary trust relevant property plus the initial value of the related A&M trust.

Deemed cumulative total

The next step is to establish a 'deemed cumulative total', which is obtained by adding together:

- the total value of chargeable transfers, including 'failed' PETs, made by the settlor in the seven year period immediately before the trust's commencement, plus
- the value of any capital that has left the trust, thus ceasing to be relevant property, in the last 10 years.

The deemed chargeable transfer and cumulative total are then added together and this amount, after deduction of the nil rate band, is used to determine the notional IHT payable (note that this is not an amount that is actually payable but it is a necessary step in the calculation process).

Example 3

Using the same facts as in Example 2. Jim had made a PET of £140,000 in March 2000 and this became a chargeable transfer on his death. No capital had been distributed from the discretionary will trust, in the first 10 years, so the deemed cumulative total for the trustees was £140,000. The nil rate band was £285,000.

The trustees are therefore deemed to make a chargeable transfer of £450,000 and have a cumulative total of £140,000. The notional amount of IHT payable on the transfer would be $(£450,000 + £140,000 - £285,000) \times 20\% = £61,000$.

Note that where the deemed cumulative total exceeds the nil rate band, the effective rate of tax will always be 20%. See Example 4.

Example 4

Continuing with the same facts as Example 3 but with a cumulative total of £750,000.

As the cumulative total is greater than the £285,000 nil rate band, the effective rate of tax, applicable to the current value of the trust fund, is 20%. Therefore the notional tax payable is £450,000 @ 20% = £90,000

Effective rate

The amount of IHT that would be payable on a chargeable transfer of all relevant trust property, as calculated in Examples 3 and 4, must be expressed as a percentage of the deemed chargeable transfer to determine the 'effective' rate.

Example 5

The effective rate using the figures from Example 3 is,

$$\frac{£61,000}{£450,000} \times 100 = 13.56\%$$

Trustees' Liability

The trustees' IHT bill is calculated by multiplying the deemed chargeable transfer by 30% of the effective rate.

Example 6

Following on from Example 5, the trustees of Jim's will trust have a payable 10-year charge, on 16 June 2006, of £450,000 x (13.56 x 30%) = £450,000 x 4.07% = **£18,315**.

As the trust asset, a holiday cottage, is one that would qualify for the IHT instalment payment option, the trustees may elect to pay this liability in 10 annual instalments.

Other issues

These are some of the other issues which may influence the tax liability on a 10-year charge. It is beyond the scope of this document to provide greater detail on these points:

- accumulated, but not undistributed income, is treated as relevant property but the rate of tax charged on accumulations is less than that for trust assets that have been relevant property throughout the 10-year period. The actual tax rate depends on the number of quarter years (periods of three months) that specific accumulations have formed part of the trust fund.
- if trustees hold assets that qualify for either business or agricultural property relief, then these reliefs can be applied to reduce asset values on the occasion of a 10-year charge.
- property that was either added to a trust or changed character, from non-relevant to relevant property, is charged to tax at a reduced rate, depending upon how many quarter year periods it has been relevant property, since the last 10-year review.
- If a settlor adds property to a discretionary trust, as a chargeable transfer, then the total of cumulative transfers in the seven years prior to that transfer, if higher, will be substituted for the deemed cumulative total, on commencement of the trust, for the purposes of calculating any subsequent 10-yearly charges.

The Proportionate (or 'Exit') charge

An IHT liability may arise when relevant property is either:

- distributed from the trust, or
- ceases to fall within the definition of relevant property, or
- trustees make a disposition which reduces the value of relevant property in the trust.

The rate of tax is a proportion of the rate charged at the previous 10-year review. If an occasion for charge arises within the first 10 years, a tax rate has to be calculated assuming that a hypothetical chargeable transfer has occurred. The charge is known as either the 'proportionate' or 'exit' charge.

The rules relating to this charge can also be complicated and therefore for simplicity only charges arising as a result of relevant property leaving the trust will be covered in any detail in this factsheet.

Calculating the charge

The rules look at each 10-year period, from creation and between periodic reviews, as if it were segmented into 40 periods of three months (often called 'fortieths'). If a proportionate charge is triggered, for example by trustees distributing capital to beneficiaries, then it is necessary to calculate how many fortieths have elapsed since the last 10-year review or since the creation of the trust, if within the first 10 years.

If a proportionate charge is triggered before the first 10-year anniversary, it is necessary to assume that a hypothetical chargeable transfer has occurred. This can be ascertained by firstly establishing the deemed chargeable transfer and deemed cumulative total as at commencement of the trust. From these figures it is possible to calculate an effective rate and then the rate of tax that would have been payable, that is 30% of the effective rate on the chargeable transfer. It is the nil rate band at the time of the distribution that is used. This rate, multiplied by $n/40$ where n is the number of complete fortieths since commencement of the trust, is then used to calculate the proportionate charge.

For distributions made after the first 10-year review it is the rate charged at the last review that is used to calculate the exit charge. This rate, multiplied by the number of complete fortieths since the last review, is then used to calculate the proportionate charge. The tax charge is based on this reduced rate. If the nil rate band value has changed since the last review, then the figures are re-worked using the nil rate band at the time of the distribution.

Example 7

Using the facts from Example 6, if the trustees sold the property and distributed £100,000 of the proceeds to one of the beneficiaries on 17 February 2009 when the IHT nil rate band was £312,000, the tax liability would be calculated as follows:

The notional amount of IHT payable would be
 $(£450,000 + £140,000 - £312,000) \times 20\% = £55,600$

The effective rate of tax is
 $\frac{£55,600}{£450,000} \times 100 = 12.36\%$

The rate of tax payable would have been
 $12.36\% \times 30\% = 3.71\%$

Number of fortieths from June 2006 to 17 February 2009 = 10

Proportionate rate of tax is
 $3.71\% \times \frac{10}{40} = 0.93\%$

Tax charge on £100,000 distribution at
 $0.93\% = £930$

If the trustees wanted to pay the £930 from the remaining trust fund, rather than deduct this amount from the distribution, then it must be grossed up as follows:

$£930 \times \frac{100}{100 - 0.93} = £938.73$

Other points

- The amount liable to the proportionate charge is based on the reduction in value of the relevant property as a result of the distribution and this may differ from the market value of the property.
- If the rate of IHT on creating the trust or at any subsequent 10-year review is nil, then any distributions in the following 10 years should also be taxed at a nil rate (although see next point concerning business property and agricultural property reliefs).
- Care needs to be taken where relevant property qualifying for either business property relief or agricultural property relief forms part of the trust fund. A trust could be created with the settled property being property qualifying for one of these reliefs at, say, 100% and no IHT would be due (the relief reduces the value to nil). If the trustees distributed property from such a trust within its first 10-year period there would have to be a reworking of the rate of tax on trust creation and this would ignore these "valuation reliefs". A tax charge could therefore arise on a distribution even though the rate of IHT on the trust creation was nil (unless the assets distributed qualify for relief in the hands of the trustees, in other words the trustees satisfy the two-year ownership and other relief criteria).
- A number of exemptions to the proportionate charge apply, including:
 - distributions made within three months of the trust's creation
 - distributions within three months after a 10-year review
 - for discretionary will trusts, distributions made within two years of the settlor's death will be exempt from the charge and treated as if they had been made by the settlor at the date of his death.

Important information

This factsheet is based upon our understanding of current tax and other legislation at the release date and may be subject to change in the future. Whilst every care has been taken to ensure the accuracy of this information, Friends Life can accept no responsibility for any actions taken as a result of this release.

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Friends Life Limited

Registered Office: Pixham End, Dorking, Surrey RH4 1QA
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www.friendslife.com Telephone 0845 602 9189

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