

TECHNICAL SALES BRIEFING

IHT "BITESIZE" SERIES - PART FIVE TRUSTS AND THEIR INTERACTION WITH INHERITANCE TAX

KEY POINTS

This Technical Sales Briefing:

- › is the fifth in a series covering many aspects of UK Inheritance Tax (IHT). The full content is available on our uTech site
- › deals with the many and varied interactions between trusts and IHT.

TRUSTS

INTRODUCTION

The Finance Act 2006 made major changes to the IHT rules for trusts, broadly bringing interest in possession trusts and accumulation and maintenance trusts into line with the existing regime for discretionary (or "relevant property") trusts.

The rules also apply to existing interest in possession trusts and accumulation and maintenance trusts, subject to transitional rules.

The rules mean that:

- › Transfers to most trusts, including IIP trusts and accumulation and maintenance trusts are taxed as "relevant property" trusts. Most transfers made on and after 22 March 2006 are treated as CLTs, so that an immediate IHT charge of 20% is payable where the settlor's available amount of NRB is exceeded (if the settlor pays the tax, the effect of "grossing up" increases the rate to 25%)
- › A periodic charge applies on all relevant property trusts of, currently, up to 6% on the value of trust assets over the NRB at each ten-year anniversary

- › An exit charge proportionate to the periodic charge will also apply when capital leaves the trust between ten-year anniversaries

The rules apply to "relevant property" trusts created on and after 22 March 2006, further transfers to existing trusts, and, subject to transitional provisions, to other IHT relevant events in relation to existing trusts.

Transitional rules provided for a period of adjustment for certain existing trusts up to 6 April 2008 (extended to 6 October 2008 for interest in possession trusts), and for continuing exclusion from the "relevant property" charges if they satisfy conditions for ongoing protection.

A trust (such as a trust written subject to the Married Woman's Property Act 1882 or an express trust) for the absolute benefit of another individual is not a settlement for IHT purposes.

The "gift with reservation" provisions are particularly relevant to trusts.



The information is based on Utmost's understanding of current law and HM Revenue and Custom's practice as at 1 July 2021. Tax rules may change and depend on individual circumstances. This information does not constitute legal or tax advice and must not be taken as such. The companies in the Utmost Group can take no responsibility for any loss which may occur as a result of relying on any information in this technical briefing.

RELEVANT PROPERTY TRUSTS

For relevant property trusts, IHT will be payable on the following occasions:

ON COMMENCEMENT

Transfers to "relevant property" trusts created on or after 22 March 2006 will constitute chargeable transfers.

TEN YEAR ANNIVERSARY OR PERIODIC CHARGE

At each ten year anniversary of the trust there will be a charge to IHT based on the value of the property then held in the trust. This is known as the ten year anniversary charge, periodic charge or principal charge.

The rate at which tax will be charged will be 3/10ths of the "effective rate" which is known as the "actual rate". The "effective rate" is the average rate of tax that would be charged by applying one-half of the rates on a hypothetical transfer made by an individual with a hypothetical cumulative total of transfers.

The hypothetical transfer is the aggregate of:

- › The value of property then held in the trust (such as the value of the policy), but excluding the value of any "non-relevant" property, and
- › The **initial value** of property in any other "related settlement" immediately after it commenced. A settlement is related if and only if it was made by the same settlor on the same day. However, changes taking effect from 6 April 2015 in respect of relevant property trusts created on or after 10 December 2014, mean that where property is added to two or more settlements on the same day, the property within the other settlements will be brought into account for the purposes of calculating the IHT charges. This measure is designed to counter avoidance by settlors using the planning strategy adopted in the Rysaffe case.

The hypothetical cumulative total of transfers is the aggregate of:

- › The cumulative total of transfers, if any, made by the settlor in the seven year period before the settlement commenced (assuming there was no further addition to the trust in the period – ref s67 IHTA 84), and
- › The value of any property which left the settlement in the preceding ten years

EXAMPLE 1

On 1 May 2021 Christopher effects a single premium whole of life policy in his sole name subject to a discretionary trust for £270,000. He has made previous chargeable transfers of £55,000 within the preceding seven years. No further (related) settlements were made on that day.

On 1 May 2031, the first ten-yearly periodic charge arises and it is necessary to value the relevant property (i.e. the policy) at that time. The policy value at this date was £425,000. To calculate the "effective rate" we need to establish:

- a) The hypothetical chargeable transfer – the value of the relevant property at 1 May 2031, i.e. £425,000. (The value of any related settlement would be added if applicable); and
- b) The hypothetical cumulative total of transfers, i.e. the assumed prior lifetime transfers in the seven years preceding the settlement, i.e. £55,000.

The "effective rate" of tax is calculated as follows:

Value of Property	£425,000
2031/32 Nil Rate Band* (escalated in line with RPI from 2025/26)	£375,000
Less previous chargeable transfers	(£55,000)
Available Nil Rate Band	£320,000
Amount of relevant property subject to tax	(£320,000)
Lifetime IHT of 20% on assumed transfer of £105,000	£105,000
	£21,000
The "effective rate" of IHT is then	$\frac{£21,000}{£425,000} \times 100\% = 4.941\%$
The "actual rate" is then calculated using 30% of the effective rate = 1.482%	
Thus the IHT payable at the ten year anniversary is: £425,000 @ 1.482% = £6,299	

There are also complex provisions under s67 IHTA 84 where there are additions to the settled property which could increase the "effective rate". Under s67 where property is added to the trust, we also need to look back seven years prior to the date property was added to the trust. This is an anti-avoidance rule to counter Rysaffe-style planning with pilot trusts created with very small initial settlement values.

Where any part of the property was not comprised in the settlement throughout the ten year period immediately before the ten year anniversary the rate of tax charged on such part of the property will be reduced by 1/40th for each of the successive quarters (periods of three months) which expired before the property became comprised in the settlement.

Note: where property subsequently becomes relevant property, the trust commencement date is always taken as the date the settlement was made as defined in s60 IHTA 1984. Where property is only relevant property for a part of the ten year period then for the purposes of the ten year anniversary, a proportionate calculation is used similar to that used in the next section.

PROPERTY LEAVING SETTLEMENT

Where any property leaves a "relevant property" trust, it will be subject to a proportionate charge based on the time that has elapsed since the commencement of the trust or from the date of the last ten year anniversary if later. This is known as the exit charge.

The rate of tax chargeable before the first ten-year anniversary will be the appropriate fraction of the "effective rate". For this purpose the appropriate fraction will be 3/10ths multiplied by 1/40th for each successive quarter since the commencement of the trust (for example after 5 years = 20). Any quarter expiring before the day on which property became comprised in the trust will be ignored. The "effective rate" is the average rate that would be charged if an individual had made chargeable lifetime transfers equal to:

- › The value of the property comprised in the trust or related trusts (see above) immediately after it commenced, and
- › The value of the property subsequently added to the trust immediately after its addition.

In many cases, particularly where the settlor had made no chargeable transfers in the seven years preceding the trust and the value of the settlor's cumulative total is within the NRB, there would be very little, if any, tax payable on property leaving the trust before the first ten year anniversary. This is because the effective rate of tax on the initial transfer will be nil.

Note here the annual exemption will reduce the transfer of value, but for the purposes of calculating exit charges in the first ten years the charge is based **on the initial value of the settlement**. This anomaly could, for example, lead to a small exit charge in the first ten years despite the transfer of value itself not giving rise to any charge to IHT.

The rate of tax chargeable between ten year anniversaries will be the appropriate fraction of the rate that was charged it was charged at the last ten year anniversary, recalculated using the NRB applicable in the year of exit if applicable.

EXAMPLE 2

Facts as for previous example, except that the life assured died on 2 May 2036, i.e. 15 years after the policy had been taken out. The policy value on death was £500,000 but there was also notional life cover of £1 per policy segment which amounted to £120. A total of £500,120 was paid to the trustees who distributed it on the date in accordance with the powers vested in them by the trust. The rate at which tax would be payable would be the appropriate fraction of the rate at which it was charged at the last ten-year anniversary, i.e.

Rate at which tax charged on previous ten-year anniversary = 1.482%

Appropriate fraction = $\frac{20}{40}$ (i.e. 5 years, or 20 quarters since last ten-year anniversary)

Therefore rate at which tax is charged = $\frac{20}{40} \times 1.48\% = 0.741\%$

Tax payable = £500,120 x 0.741% = £3,706

This assumes beneficiary pays exit charge, if the trustees pay the tax the actual rate of tax on exit is grossed up.

INTEREST IN POSSESSION TRUSTS CREATED BEFORE 22 MARCH 2006

Transfers before 22 March 2006 to a trust where there is an interest in possession (a right to the income generated by the trust fund) were treated as potentially exempt transfers. For IHT purposes, an interest in possession held under such a trust is treated in the same way as absolute ownership of the whole, or part, of the trust property in which the interest subsists.

This treatment will continue until the current interest in possession (that was in place as at 22 March 2006) comes to an end. If, when the current interest in possession comes to an end, another/other individual(s) then take(s) absolute ownership, there will be the usual consequences – a PET if the current holder of the interest in possession is alive, or a chargeable transfer on death.

If the interest in possession comes to an end after 5 October 2008 and the trustees choose to exercise their power of appointment in favour of a new beneficiary, this will be treated as the creation of a new relevant property settlement. If this happens during the lifetime of the current holder of the interest in possession, there will be a chargeable transfer.

If it follows the death of the current holder of the interest in possession, the trust fund will be in the estate of the deceased beneficiary. In either case, there could be subsequent ten-year anniversary and exit charges with the first ten year anniversary charge following death apportioned based upon the period for which the property was relevant property.

Great care is required on the part of trustees in circumstances where (a) they are considering making an appointment away from the current holder(s) of the interest in possession after 22 March 2006, or (b) in the event of the death of such beneficiary. If the trustees were contemplating a change in the beneficiaries entitled to the interest in possession they should have made such an appointment before 6 April 2008 (extended to 6 October 2008) in order to preserve the existing IHT treatment of the trust. Any appointments after that date fall within the current rules.

PROTECTED INTERESTS IN POSSESSION

Further transitional protection is available in certain limited circumstances, where an interest in possession will remain within the "old" rules even though the holder became entitled to it on or after 22 March 2006. These include:

- › Immediate post-death interests; and
- › Transitional serial interests.

IMMEDIATE POST-DEATH INTERESTS (IPDIS)

To qualify as an IPDI, all the following conditions have to be met, in relation to the life tenant:

- › The trust must be created by will, or under the intestacy rules. This requirement immediately rules out interest in possession trusts created during the settlor's lifetime
- › The life tenant must have become beneficially entitled to the interest in possession on the death of the settlor or intestate person

- › The interest in possession must not be a bereaved minor's or disabled person's interest.

Under these provisions, a life interest for a surviving spouse/registered civil partner will normally qualify as an IPDI, and therefore attract the spouse exemption. However, if on the spouse/registered civil partner's subsequent death, the children acquire only a life interest in the trust, their interest in possession will not qualify as it does not meet the condition that the interest is acquired immediately on death.

TRANSITIONAL SERIAL INTERESTS (TSIs)

TSIs refer to interests in possession that apply to several circumstances:

- 1) **S49C IHTA 1984.** The interest came to an end between 22 March 2006 and 5 October 2008, and was replaced. This 'transitional regime' has now ended but would have applied where:
 - › The trust commenced prior to 22 March 2006
 - › Immediately before that date an individual had an interest in possession
 - › The interest in possession comes to an end between 22 March 2006 and 5 October 2008
 - › On that coming to an end, another individual becomes entitled to the interest in possession
 - › That interest is not a disabled person's or bereaved minor's interest.

Under these circumstances, the pre-22 March 2006 treatment of the interest in possession will continue to apply until the termination of the subsequent interest in possession. These rules allowed for trustees to change the beneficiary entitled to the interest in possession without being penalised by the changes introduced.

Following this transitional period only two other TSIs can be created:

- 2) **S49D IHTA 1984** Where an individual has an interest in possession under a pre-22 March 2006 trust and, on the death of that individual after 5 October 2008, the interest in possession passes on their death to the deceased's spouse or registered civil partner. If this condition applies the spouse/registered civil partner's interest in possession would continue to be subject to the pre-22 March 2006 rules as long as the IIP lasts. Of course the passing of this IIP would also be fully exempt under the spousal exemption providing the recipient was UK domiciled.
- 3) **S49E IHTA 1984** Where a trust holds a policy of life assurance and a successive interest passes automatically via the trust provisions. Note this provision does not apply to capital redemption policies.

Note neither S49D or S49E IHTA 1984 apply where the trustees use their powers of appointment during lifetime. If the trustees use their powers of appointment this will not result in a TSI and this portion of the trust fund will fall into the relevant property regime.

ACCUMULATION AND MAINTENANCE TRUSTS CREATED BEFORE 22 MARCH 2006

Trustees of existing accumulation and maintenance (A&M) trusts (those in place as at 22 March 2006) had until 6 April 2008 to consider what steps, if any, they wish to take to determine the IHT treatment of the trust. They had a choice between three options:

- › Appoint the trust fund absolutely to the beneficiaries on their reaching age 18. In this case, there is no change to the IHT position of the trust, which will retain its beneficial IHT treatment under the pre-2006 Budget regime
- › Amend the terms of the trust to appoint the property absolutely to the beneficiaries at age 25. In this case, the trust would be referred to as an 18-25 trust and, provided certain conditions are complied with, will not suffer a ten year anniversary (or principal) charge. The main conditions are that any income has been either accumulated within the trust or applied for the beneficiary's benefit, and that no income can be applied for the benefit of any other person other than where the amounts distributed to (other) beneficiaries are under 3% of the trust fund value or £3,000, whichever is lower. An exit charge will arise when the trust fund is finally appointed to the beneficiary. The maximum rate at which IHT would be charged is therefore 4.2% (7/10ths of 6%) which would apply if the capital is distributed at age 25
- › Make no changes, leaving the trust to fall into the "relevant property" regime, with the periodic and exit charge provisions. The first periodic charge will arise on the next 10-year anniversary of the trust, which will be a part charge, apportioned to the period falling after the date the beneficiary attains age 18 (or 6 April 2008 if later). There is no charge on the trust fund entering the IHT "relevant property" regime.

It is fair to say that, in practice, many trusts will have left the original A&M provisions untouched and will have thus fallen into the relevant property regime. This point was a particularly draconian aspect of the 2006 trust changes. After all, if the original A&M trust didn't appoint the capital before, or at, age 18, the options given to amend the existing A&M trusts all required the trust to appoint benefits prior to an age the settlor originally intended.

EXCLUDED PROPERTY TRUSTS

An individual who is neither domiciled nor deemed domiciled in the UK is not liable to IHT on any assets other than UK sited assets. So an individual neither domiciled nor deemed domiciled in the UK who "settles" foreign assets outside the UK before becoming domiciled in the UK will have those assets treated as "excluded property" for the purposes of IHT.

This remains the case even if such an individual subsequently becomes UK domiciled or deemed domiciled unless the person was born in the UK. No UK IHT will arise on distributions to beneficiaries even if they are living in the UK. The settlor can be included as a beneficiary under such a trust with no adverse UK IHT consequences.



A full briefing explaining excluded property trusts and other aspects of non-resident taxation is available on our uTech site.

EXEMPTIONS AND RELIEFS

There are various exemptions for trusts related to "sponsored superannuation schemes" and to "registered pension schemes".

There are also exemptions relating to certain trusts for charities, employees, compensation funds, bereaved minors, mentally disabled persons, persons in receipt of an attendance allowance, for political parties and for protective trusts under s.33(1) Trustee Act 1925.

FURTHER UPDATES IN THIS SERIES AND OUR UTECH SITE

The next Technical Sales Briefing in this series will look at life assurance policies and IHT

Note the content in this briefing is taken from our comprehensive Inheritance Tax Manual which is available in the Technical Briefings section of our uTech site (www.utmostinternational.com/wealth-solutions/our-wealth-solutions/united-kingdom/utech). uTech has several other technical briefings exploring the more niche and complex areas of UK IHT. These include several guides to the Residence Nil Rate Band and a detailed briefing exploring Domicile, Remittance Basis and Excluded Property.

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