AF1/J02
Part 4: Taxation of Trusts (5) 2023/2024
Trusts and IHT

This final part of taxation will cover the IHT treatment of trusts.

The milestones are to understand:

- Which trusts are subject to the relevant property regime and which are not
- How lifetime transfers into different trusts are treated.
- How IHT applies to non-relevant property trusts on the death of the beneficiary, advancement of capital and change of beneficiary.
- How periodic and exit charges for a Relevant Property Trusts are calculated.
- How the Rysaffe principle works
- The IHT treatment of an Accumulation and Maintenance Trust

IHT seeks to tax the transfer of property from one party to another so making either a lifetime gift or passing a deceased person's property into a trust will be subject to IHT. The tax status of these gifts will depend on whether the trust is classed as a:

- Relevant Property Trust
- Non-Relevant Property Trust

The trusts that fall under the relevant property regime are:

- Discretionary trusts (no matter when it was set up)
- Interest in Possession trusts set up after 22 March 2006
- Interest in Possession trusts where there has been a change in beneficiary since October 5 2008.

Trusts that are non-relevant are:

- IIP trusts set up before March 22 2006 (and where there has been no change of beneficiary since October 5 2008) These are called Qualifying Interest in Possession Trusts.
- Bare trusts
- Trusts for the disabled
- Immediate Post Death Interests (IPDI)
- Trusts for bereaved minors.

The key differences in the IHT treatment of these two types are:

- Lifetime gifts into a non-relevant trust will be a PET (and possibly exempt)
- Lifetime gifts into a Relevant Property Trust will be a CLT

- The trust property of a relevant property trust belongs to no one for IHT purposes and will not be considered part of their estate but periodic and exit charges will be applied.
- The trust property of a non-relevant trust will be considered part of the deceased's beneficiary's estate but will not be subject to periodic and exit charges.

Non-Relevant property trusts

Lifetime Transfers

Lifetime transfers to Bare Trusts and Trusts for the Disabled are Potentially Exempt Transfers (PETS). This means that no tax is payable when the gift is made and it will be totally exempt if the settlor survives seven years.

If the settlor dies within seven years of the gift, IHT will be chargeable at 40% on the excess over the NRB at date of death. This will be payable by the trustees although taper relief will reduce the tax if the settlor survived three years after making the gift.

Gifts made into a pre-March 22 2006 IIP would also have been PETS and as more than seven years have passed since 2006 all these will now be exempt. Any further gifts into a pre-March 22 2006 IIP trust will be a CLT and would bring that portion of the trust into the relevant property regime.

IHT on death

A death transfer into a non-relevant property trust will be chargeable unless the beneficiary is a spouse or civil partner. This will reduce the NRB available to the estate.

When the beneficiary of a non-relevant property trust dies, their share of the trust property is included in their estate. The tax is calculated and split proportionally between executors and trustees.

Carla dies and has a personal estate of £400,000. She is the beneficiary of an IPDI trust worth £125,000

Tax liability is £525,000 less £325,000 x 40% = £80,000

The estate share is £400,000/£525,000 x £80,000 = £60,952
The trustee's shares is £125,000/£525,000 x £80,000 =£19,048

This is also the process for a trust for the disabled, IPDI trusts and Bereaved Minor's trusts

With a bare trust the property is part of the deceased's estate and all tax will fall on the deceased's executors.

Transfer and advancement of capital

Trustees of a pre-March 22 IIP trust and an IPDI are usually allowed to:

- Pass the trust property to the beneficiary, i.e. take it out of the trust.
- Pass the trust property to someone else taking it out of the trust.
- Change the named beneficiary to another person.

The consequences are as follows:

Rebecca is the beneficiary of her late husband's IPDI trust. If the trustees pass the property absolutely to Rebecca there are no IHT implications as Rebecca is already deemed to be the owner. (This would also apply if the beneficiary was someone other than the spouse)

John is a beneficiary of his late mother's IPDI trust. The trustees decide to advance the property absolutely to his sister Carol. This is a PET on behalf of John.

Raj is a beneficiary of his late father's IPDI trust. The trustees decide to amend the beneficiary to Raj's child Shama. The transfer is a CLT on behalf of Raj. The trust property then enters the relevant property regime

Change of beneficiary or advancing capital is not usually an issue with Bare Trusts, Trusts for the Disabled or Trusts for Bereaved minors.

- The beneficiary of a bare trust can demand the property at any time and this would have no IHT implications.
- Trusts for the disabled and trusts for bereaved minors are obviously designed to benefit one individual so a change of beneficiary is not an issue.
- The trustees of a bereaved minors trust must give the property to the beneficiary when they reach 18.

Relevant Property Trusts

Lifetime Transfers

A lifetime gift will be treated as a Chargeable Lifetime Transfer, which means that any payment more than the current nil rate band will be immediately chargeable at 20%.

> Tony has never made any CLTs. He sets up a Discretionary Trust and pays £100,000 into it. (For simplicity, the annual exemption which could have reduced the gift by £6,000 is ignored). Whilst it's a CLT, there is no tax to pay as it is below the NRB of £325,000.
>
> Suzanne has also never made a CLT and pays £525,000 into an Interest in Possession Trust. This is £200,000 in excess of the NRB so tax is immediately payable.
>
> Tax is payable at half the full rate, i.e. 20% so the tax due is £200,000 x 20% = £40,000 which is payable by the trustees.
>
> If the donor pays tax will be charged at 25% (£50,000 tax)

In both the previous cases there had been no earlier gifts but CLTs are cumulative so any CLT made in the **previous seven years** must be taken into account.

Whenever a CLT is made you must look back seven years from the date of the transfer and see if any other CLT's were made in this period. If they were the earlier gift is subtracted from the current NRB and then the current CLT is deducted from this figure to calculate the taxable amount.

> Boris made a gift into a Discretionary Trust of £225,000 on 1/5/15. No tax was payable as it was below the NRB for that year.
>
> He makes a second gift of £250,000 in June 2020. This was also below the current NRB (£325K) but since the first gift was made within the previous seven years it must be taken into account.
>
> The first gift is deducted from the current NRB (£325,000 less £225,000 = £100,000). This means £150,000 is chargeable (£250,000 less £150,000)
>
> The amount of tax due if the recipient pays is £150,000 x 20% = £30,000.
>
> If Boris wishes to pay the tax the amount due will be £150,000 x25% = £37,500

If the donor dies in the seven years following the gift, tax is recalculated. The excess of the gift over the NRB <u>at date of death</u> is chargeable at 40%. This is payable by the trustees. Taper relief can be claimed and the amount of any tax paid at the time of the gift can be deducted.

The following table shows the tax chargeable on a £350,000 gift. Tax at the time of the gift was £5,000 (£350K less £325K @ 20%.) Assuming that the NRB stays at £325K the tax paid on death would be as follows

Years since gift	Tax payable	Tax already paid	Balance due
0-3	£10,000	£5,000	£5,000
3-4 (20% taper)	£8,000	£5,000	£3,000
4-5 (40% taper)	£6,000	£5,000	£1,000
5-6 (60% taper)	£4,000	£5,000	Nil
6-7 (80% taper)	£2,000	£5,000	Nil

Note that if the tax due on death is less than tax paid at the time of gift there is no refund.

If a joint gift is made, say by a husband and wife, each person is considered to have made a separate trust so each can use their own NRB so a joint gift under £650,000 would not incur an immediate charge.

To summarise the full position on lifetime transfers:

- IHT is payable on the excess of the value of the transfer over the current available nil rate band.
- The chargeable value of the gift can be reduced by two annual exemptions of £3,000 each
- Tax is charged at 20% if paid by the trustees or 25% if the donor pays the tax
- If the donor dies within 7 years of the transfer the excess of the gift over the NRB in the year of death will be assessed at 40%
- Any tax due will be reduced by taper relief with credit for tax paid at the outset
- If the tax paid when the gift was made is higher than the tax paid on death there is no refund of tax.
- Any IHT is payable by the trustees

IHT on death

A transfer to a relevant property trust from a deceased's estate reduces the estate's NRB and any tax falls on the estate rather than the trustees receiving the gift.

When beneficiary of an RP trust dies, their share of the trust property will not be included in their estate. Instead it subject to **Periodic** and **Exit** charges.

Periodic and exit charge

On each 10th anniversary of the trust being set up the whole trust is subject to a **PERIODIC** or **PRINCIPAL** charge.

Each time **capital** is withdrawn from the trust it is liable to an **EXIT CHARGE**.

These are complex calculations so any question in the exam is likely to focus on the basics.

Periodic Charge

The basic formula for a periodic charge is:

Value of trust at every 10th anniversary less NRB at that date x 6%*

The 10th anniversary of the Rice Trust falls in May 2020. The value of the trust is £525,000. £525,000 less £325,000 = £200,000 £200,000 x 6% = £12,000

**This is a "short cut" method but it has been used in past exam guides so it is acceptable. The way that HMRC do it is as follows:*

£200,000 @ 20% = £40,000
Tax as a % of chargeable value £40,000/£200,000 = 20%
20% x 30% = 6%
Tax on £200,000 @ 6% = £12,000

It follows that if the value of the trust is below the NRB at the date of calculation there will be no charge.

If there had been any payments from the trust in the previous 10 years these would have been added back.

The Miller trust has its 10th anniversary on September 1 2020. Its value is £300,000 but £200,000 was paid out in 2017 The periodic charge is £300,000 + £200,000 less £325,000 = £175,000 £175,000 @ 6% = £10,500

Exit Charge

There are two different calculations. One where property is transferred out after the 10th anniversary and another where this occurs in the first 10 years. The calculation is easier for a post 10th anniversary transfer so let's start with that.

The starting point is to calculate the **effective rate of tax** at each 10 year anniversary. This is the periodic charge divided by the value of the trust

The Rice trust paid a £12,000 periodic charge. The value of the trust was £525,000 The **effective rate** is £12,000/£525,000 which is 2.286%.

This is then applied to the amount being withdrawn.

This figure is then reduced by the **relevant fraction**. This is the number of **complete quarters** between the trust's last 10th anniversary and the date of the distribution divided by 40, which is the number of quarters in a 10 year period.

£100,000 is paid out from the Rice trust on the 12th anniversary. The exit charge would be:

£100,000 x 2.286% x 8 quarters/40 = £457.20

If there was no periodic charge at the 10th (or subsequent 10 year anniversaries) then there cannot be an exit charge as the effective rate would be zero.

Also note that as the relevant fraction is based on complete quarters there is no exit charge if property is transferred within the first three months after the 10th anniversary.

Calculating the exit charge in the first 10 years is more complex because as no periodic charge has been made there is no effective rate. Another process is needed to establish this.

The process is:

1. Deduct the NRB at the date of payment from the initial value* of the trust.
2. Charge this excess at 20%
3. Divide this notional tax by the initial value of the trust

A trust has an initial value of £385,000 when it was set up in May 2016. A capital sum of £50,000 was made to a beneficiary in May 2020 when the NRB is £325,000.

£385K less £325K = £60K
£60K @ 20% = £12,000
£12,000/£385,000 = 3.12%

**Researching this point, some sources state that you deduct the NRB at the time of the gift, others state you deduct the NRB when the trust was set up. This may be a little academic since the NRB has been £325,000 since 2009/2010. Any question will probably have the scenario that a capital sum is being paid in 2022/2023 and as this will be before the 10th anniversary the NRB will have been £325,000 when the trust was set up.*

The number of complete quarters between the trust's inception and the date of the distribution is calculated and divided by 40. This is then multiplied by 30% of the effective rate. Following on from the above example:

£50,000 x 30% x 3.12% x 16/40 = £188

An alternative method

Periodic charge £60,000 x 6% = £3,600 (because 30% of 20% is 6%)
Effective rate is £3,600/£385,000 = 0.94%
£50,000 x 0.94% x 16/40 = £188

As ever, if the value of the trust when the capital is paid is less that the NRB there will not be an exit charge. There is, however, another time when there will not be an exit charge. This is when there is a distribution from a Discretionary Will trust withing two years of the testator's death.

Alan died on May 1 2021 and in his will set up a Discretionary Trust with an initial gift of £500,000. The trustees decide to pay £100,000 to one of the beneficiaries. Provided this is done before April 30 2023 there will be no exit charge.

Any distributions made on or after May 1 2023 will be subject to an exit charge.
Periodic and exit charges are payable by the trustees. There is no charge on the beneficiary.

The Rysaffe principle

The Rysaffe principle relates to a case in which it was held that if a settlor gifted into different RP trusts <u>on separate days,</u> each trust

Setting up separate trusts can still be advantageous as in the following example.

Ian always used his annual allowance and on September 1 2009 when the NRB was £325,000, he gifted £500,000 into a Discretionary Trust. On September 1 2019 its value was £800,000.

The initial charge would have been:

Gift	£500,000	
Less NRB	<u>£325,000</u>	
Chargeable amount	£175,000 @ 20%	£35,000
%		

Let's say he had set up five separate trusts with £100,000 each on separate days.

Trust 1	£100,000	
Less NRB	<u>£325,000</u>	
Remaining NRB	£225,000 (no charge)	
Trust 2	£100,000	
Less NRB	<u>£225,000</u>	
Remaining	£125,000 (no charge)	
Trust 3	£100,000	
Less NRB	<u>£125,000</u>	
remaining	£25,000 (no charge)	
Trust 4	£100,000	
NRB	<u>£25,000</u>	
	£75,000 @ 20%	£15,000
Trust 5	£100,000 @20%	£20,000
No NRB so all chargeable.		

The total is £35,000 so there is no difference between this and a single gift but let's move on to the periodic charge

Using one trust Ian's periodic charge will be:

Trust value	£800,000	
Less NRB	£325,000	
Amount chargeable	£475,000 @ 6%	£28,500

Using five trusts (each with a value of £160,000) the periodic charge will be

Trust 1

NRB	£325,000
Less Trust value	£160,000
Balance	£165,000 (No charge, fund less than the NRB)

Trust 2

NRB	£325,000
Previous CLT	(£100,000)
Balance	£225,000 (no charge, fund less than NRB)

Trust 3

NRB	£325,000		
Previous CLTs	£200,000	£160,000	
Remaining NRB	£125,000	£125,000	
Chargeable		£35,000 @ 6%	£2,100

Trust 4

NRB	£325,000		
Previous CLTs	£300,000	£160,000	
Remaining NRB	£25,000	£25,000	
		£135,000 @6%	£8,100

Trust 5

NRB	£325,000		
Previous CLT	£400,000	£160,000	
NRB	0	0	
		£160,000 @ 6%	£9,600
Total periodic charge			**£19,800**

By setting up five separate trusts Ian has saved £8,700 in periodic charges because each trust has its own NRB.

Another way to use the Rysaffe principle is to set up "pilot trusts" on different dates. These receive a nominal amount, say £100, and further amounts can be added later. The 10 year anniversary is set when the pilot trust is set up and not when the additional amount is added.

The 18 to 25 trust

A trust for a bereaved minor is not relevant property and isn't subject to the periodic/exit charge regime.

Parents may feel uncomfortable that if they die, their bereaved child gets an absolute right to the trust property at 18. They would probably prefer to give the trustees more flexibility. This can be achieved by setting up an 18 to 25 trust in their will that gives the trustees the power to give the child absolute benefits at any time between the child's 18th and 25th birthday.

If the beneficiary dies before 18 it will be treated as a trust for bereaved minor. If the trustees decide to continue the trust after the beneficiary reaches 18 it will enter the relevant property regime but there will be no initial charge.

It will be subject to an exit charge but only if the transfer is greater than the NRB at that time. The starting date for calculating the relevant fraction will be when the child reaches 18, that is the number of complete quarters from the 18th birthday to the date when capital is paid to the beneficiary. As there are 28 quarters between 18 and 25, the maximum charge would be:

28/40 x 6% = 4.2%

> Thirza is the beneficiary of an 18 to 25 trust set up on the death of her father.
>
> On her 21st birthday in August 2020 the trustees pay out the full value of the trust which is £600,000.
>
> The exit charge will be
>
> (£600,000 less £325,000) x 6% x 12/40 = £4,950

The IHT treatment of an Accumulation and Maintenance Trusts

These ceased to be available following the 2006 Budget. Their main use was to assist grandparents make lifetime gifts into a trust for the benefit of their grandchildren.

The original gift would have been a PET. The beneficiary had a right to capital by their 25th birthday but the trustees could advance capital before then.

Following their withdrawal, the trustees of an existing A & M trusts had three options and had until 6 Aril 2008 to make their election.

- They could do nothing which meant that the trust became relevant property from 6 April 2008.

- This meant there could be periodic and exit charges and these would apply from the original settlement date.

Sam set up an A & M trust with an initial gift of £500,000. his grandson on 1 March 2002. The trustees decided not to amend the trust so it became RP on 6 April 2008. The first periodic charge would be due on 1 March 2012

- The trustees could amend the trust so that the beneficiary(ies) had an absolute entitlement at age 18.
- No periodic or exit charges would apply.

- The trust could be amended so the beneficiary(ies) became absolutely entitled at age 25
- It would then be treated like an 18-25 trust with an exit charge based on the number of quarters between 18 and 25
- But no periodic charge

That concludes this part so you should now understand:

- Which trusts are subject to the relevant property regime and which are not
- How lifetime transfers into different trusts are treated.
- How IHT applies to non-relevant property trusts on the death of the beneficiary, advancement of capital and change of beneficiary.
- How periodic and exit charges for a Relevant Property Trusts are calculated.
- How the Rysaffe principle works
- The IHT treatment of an Accumulation and Maintenance Trust

Further Reading

https://www.gov.uk/trusts-taxes/trusts-and-inheritance-tax

https://www.canadalife.co.uk/adviser/ican-academy/briefing-notes/estate-planning-trusts/periodic-and-exit-charges-briefing-note

https://www.pruadviser.co.uk/knowledge-literature/knowledge-library/discretionary-trust-taxation/

https://adviser.royallondon.com/technical-central/protection-guidance/inheritance-tax-and-related-manuals/rysaffe-principle/