CHESTERTONS

Inheritance Tax (IHT) and trusts

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The Government has recently made a number of important announcements with regard to the taxation of residential property in the United Kingdom. We summarise below the key changes regarding IHT with regard to property trusts and what the implications are for anyone either currently owning or thinking of buying UK residential property. Whilst the scope of these announcements in some cases has a wider impact, this note focuses purely on the implications as they relate to residential property.

Background

HMRC has been looking at ways of simplifying the inheritance tax system as it relates to trusts over the past couple of years. The third and most recent consultation, which ended on 29th August, has proposed changes to the current charges system which will have implications for anyone owning assets in trust.

What is the current situation?

It is currently possible for an individual to give away up to the Nil-Rate Band IHT Allowance (£325,000 for the tax year 2014/15) in any seven year period without incurring an IHT charge. Trusts can also make use of a Nil-Rate Band allowance in determining the IHT payable:

- when a trust reaches a 10-year anniversary of its creation
- when assets are transferred out of a trust or the trust comes to an end

Trust assets with a value below the Nil-Rate threshold are not subject to the 10-year anniversary and exit charges when they leave the trust. Prior to 2006 certain trusts fell outside these rules, as follows:

- assets held in an "interest in possession trust" (i.e. one where a beneficiary has the right to income arising from it) were treated as belonging to the income beneficiary and the value was taxed on the beneficiary's death subject to his Nil-Rate Band. This continues to apply to a number of special cases:
- "transitional serial interest" (life interest) trusts set up between 22 March 2006 and 5 October 2008
- immediate post-death interests
- trusts for bereaved minors
- age 18 to 25 trusts
- trusts for disabled beneficiaries
- bare trusts (which are in truth simple nominee arrangements)

The Nil-Rate threshold which is available for a trust is reduced to take account of 'chargeable transfers' made by the settlor at or during the seven years before the time the trust is set up. IHT liability will be reduced if assets are placed in a number of trusts (provided they are not made on the same date) as multiple Nil-Rate bands will apply.

IHT is currently paid by individuals on death at the rate of 40% on amounts in excess of the nil-rate threshold. Certain agricultural and business property is exempted. Those who leave 10% or more of their net estate to charity can choose to pay a reduced rate of 36%. A 20% charge is payable during lifetime (on the value above the nil-rate threshold) when property is put into a trust. The trustees' own 10 year anniversary and exit charges are taxed at a maximum rate of 6%.

What are the proposed changes?

HMRC has proposed the following changes:

- replacing existing tax rates for 10 year and exit charges with a flat rate of 6% of the chargeable transfer, reduced in the case of exit charges to reflect the proportion of the 10 years since the last charge or the property entered the settlement;
- providing in legislation that accumulated income added to capital is IHT liable from the date at which the accumulation took place for the purpose of the 10 year and exit charge calculations;
- deeming undistributed income arising to certain trusts to be accumulated and added to capital if it remains otherwise unaccumulated for more than five years at the date of charge;
- alignment of IHT filing and payment dates for 10 year and exit charges;
- additions to existing trusts will be deemed to create a separate trust and will be subject to the new rules for the purposes of calculating 10 year and exit charges
- following consultation launched after Budget 2014, the Chancellor announced in his Autumn Statement that he will not now introduce a single settlement nil-rate band for multiple trusts as previously proposed. The government will however introduce new rules to target the use of multiple trusts.

These new rules will take effect from tax year 2015/16. However, because HMRC is concerned that taxpayers will try to take advantage of the previous rules (e.g. to establish a series of settlements) the rules will apply to all settlements established on or after 6 June 2014. They will also apply from this date to additions to existing settlements and changes to existing settlements where property first becomes liable to IHT. Thus these new rules are effectively already in place.

In relation to settlements in place before 6 June 2014, the old rules will continue to apply to the extent that they determine the amount of the Nil-Rate threshold applicable to a settlement.

What are the potential implications for you?

The good news is that the proposal to introduce a single trust lifetime nil-rate band allowance threshold (entirely separate from the nil-rate band for general inheritance tax purposes) - meaning that multiple trusts would cease to benefit from their own separate nil-rate thresholds - has been dropped. However, we await details of the Chancellor's intention to introduce new rules to target the use of multiple trusts.

The proposed changes could have substantial negative implications for trusts and those who intend to set up a trust. Many people may have set up trusts without being fully aware of the implications, for example in connection with life assurance.

The taxation of trusts is an extremely complex area and it is highly recommended that you consult with a specialist tax advisor in order to ascertain what, if any, action should be taken in response to the proposed changes.

We are grateful to PWC for their assistance in putting this note together. For further information please contact:

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