Some assembly required

Inheritance tax and trusts

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Danny Clifford provides practical guidance on ensuring that advisers have all the information they need when dealing with a ten year charge

Key Points

What is the issue?

The ten year charge exercise often results in a relatively straightforward calculation, but the onus is on the adviser to ensure that all relevant factors have been taken into account.

What does it mean to me?

Understanding some of the nuances of the ten year charge calculation is necessary in order to ensure that the right questions are asked of the client and trustees, and the relevant information is obtained.

What can I take away?

Do not assume. Ask all pertinent questions and keep a permanent record of all of the responses.

Is there something I should know?

The calculation of the ten year anniversary Principal Charge is something of a bête noire for many of us who deal with such charges only a few times each year.

It seems to be the case that often the information gathering, rather than the calculation itself, is the part that takes up the most time. The problem is that unless I already have all of the relevant details about the trust and the settlor on my files I will have to ask the client (or possibly their previous advisers) for what can potentially be a substantial amount of information in order to proceed. Drafting a request for such information can feel odd as I am often typing out questions the answers to which I'm almost certain I can correctly guess. This is because the well-advised client will probably have followed a distinct course of action in setting up and running their trust.

Let us suppose that the client established a relevant property trust and settled property into it on 19 September 2006. I have chosen a date where, hopefully, all trust advisers were 'on the ball' as far as the issues surrounding relevant property trusts were concerned, and which makes the first ten year charge (19 September 2016) of immediate relevance. This is a client for whom I have not previously acted and who has sought my assistance because they understand there may be a ten year IHT charge due in respect of their trust. What information am I looking to obtain from the client in order to progress the calculation?

My own way

I find it helps to consider the mechanics of the charge in three parts, being:

1. Calculation of the value of the relevant property within the settlement.
2. Calculation of the rate of tax.
3. Application of the rate of the tax to the property and establishing the tax due.

Turning first to the calculation of the value of relevant property. The ten year charge date is 19 September 2016 so I will therefore need a valuation of all of the relevant property within the trust on the day before the ten-year anniversary date, i.e. 18 September. Some values may be straightforward to acquire (e.g. bank account balances and portfolios of quoted securities run by an investment manager) but the valuation of other assets such as land, buildings and unquoted shares can certainly be somewhat more involved. Further, before I can start to obtain valuations I need to establish exactly what it is that I need valued – what is the relevant property within the settlement? Identification of what is relevant property is not always as straightforward as one might hope. A thorough review of the trust deeds may be necessary to determine whether any of the property in the trust is held on such terms that it has never become relevant property, because such property is no longer taken into account when calculating the rate of charge. Additionally, if there is undistributed income within the trust I will need to know when this has arisen. For any ten year charge arising after 5 April 2014 the treatment of such balances is prescribed – that which arose more than five years before the ten year charge date will be subject to the charge as if it had been comprised within the settlement for the full ten years, and that which arose within the last five years of the period will not. Hopefully annual accounts will be available to enable identification of which applies. As a planning point, had there been undistributed income that did arise within the first five years, it would have been possible for the trustees to consider, prior to the ten year anniversary, formally accumulating that income. Had they done so it should only be treated as capital from the date it became accumulated.

Careless memories

Calculating the rate of tax is then going to require some 'historic investigation'.

First, are there any related settlements? There are traps here! The answer cannot be established merely by looking at what currently exists. Related settlements are settlements, other than charitable settlements, created by the same settlor on the same day (in this case 19 September 2006). Asking the client whether he has any other existing settlements does not necessarily get you the right answer however, since the initial value of a related settlement needs to be included within this calculation even if that settlement itself has since ceased to exist. One might be tempted to assume that there will not be any related settlements because the well advised settlor would have been directed to avoid creating multiple settlements on the same day. However that is to ignore the collateral damage caused by the provisions of Finance Act 2006. Prior to this it would not have been a problem to establish, for example, both an A&M settlement and a life interest settlement on the same day. Both were potentially exempt transfers and neither had the spectre of IHT charges hanging over them. Following FA2006 it became quite possible that the A&M Settlement (in particular) had an IHT ten year charge exposure and thus the life interest trust established on the same day would be a 'related settlement'. Changes made by Finance (No 2) Act 2015 mean that, at least in the case of 18-25 trusts, only other 18-25 trusts settled on the same day are related settlements – a useful simplification.

However, what is given with one hand is taken with the other and that same Finance Act also introduced legislation that means that, from 10 December 2014, any same day additions into two or more existing settlements have the result of bringing not only the value of those additions, but also the initial value of each settlement into the ten year charge calculation of the other.

Unfortunately we can only advise clients on the basis of the legislation as it stands at that time so subsequent changes to the rules mean that even the well advised can be 'caught out'.

Moving on, the next stage is to establish:

- The chargeable transfers (whether into trusts or not) made by the settlor in the seven years prior to settling the trust and
- Any distributions of relevant property from the trust during the last ten years (whether or not subject to an exit charge).

Hopefully accounts covering the full period together with all of the trust deeds will be available to check for relevant property appointments out of the settlement within the last ten years. As to the settlor's seven year chargeable transfers – with luck, the settlor or his previous adviser has this information to hand. The period under consideration stretches back at least 17 years! Although most relevant property trusts are established to utilise the nil rate band and generally that is on the basis that there were no prior chargeable transfers eating into that band. The position needs to be properly checked and established.

Save a prayer

At this point you might breathe a sigh of relief. At least this element is constant.

There is another catch here however. It is tempting to follow the golden rule that, once established, that seven year cumulative total will never change as it is a historic figure – but the figure can be 'replaced' with a higher figure if the settlor has added property to the settlement subsequently, and his seven year cumulative total prior to that addition is higher. It is, therefore, not enough to ask for the cumulative total for the seven years prior to 19 September 2006; we must also check the accounts and returns to see if there have been any subsequent additions of property. Again, this makes the point that even the most straightforward elements cannot always be taken at face value.

Having acquired all of the information necessary to establish the rate of tax and the amount of relevant property we are on the home straight. However, it is not always merely a matter of applying one to the other.

If assets that are relevant property have not been relevant property throughout the previous ten years (and this will include income that has been accumulated, if any) there is an adjustment such that the tax is reduced for the period that it was not relevant property. This is done on the basis of the number of complete quarters that the property was not relevant property. It does mean, however, that merely identifying what is and is not relevant property at the ten year charge date is not sufficient; we also need to note at which point that property became relevant property.

Notorious

There are certain types of trust where one is automatically 'on the alert' for this point – for example old-style A&M Trusts or 18-25 trusts, where by their very nature there is a probability that such a restriction will apply. However the possibility that property has changed character within other settlements should not be dismissed out of hand.

Summary

The amount and nature of the information required to correctly calculate the ten year charge should not be underestimated. The foregoing gives pointers but necessarily glosses over more detailed aspects, such as the fact that pre-27 March 1974 settlements have a different ten year charge calculation, as space does not allow for every variation or exemption to be explained.

Where the client is new to you and you are working from scratch you will need to be considering all of the above at the outset.

Where you deal with a trust from its inception it would be wise to keep a single 'permanent list' of all of the information in relation to that settlement that will be required when the time comes to consider the ten year charge (or indeed any exit charge). Not having to back track to identify those transactions will save a considerable amount of time (and cost) at the ten year anniversary.

That said, as mentioned earlier, even the best laid plans can go awry when politicians get involved. Following FA 2006, many trusts where, at the time of creation, one would not have envisaged any future relevant property issues became caught up in this IHT regime. As a result, information will be required to complete the ten year charge calculation in respect of such settlements that nobody had any cause to keep a record of at the time – the creation of the trust originally having been a potentially exempt transfer. Obtaining that historic information can be even more of a challenge.

Unfortunately it is often a case of having to undertake the investigative work just to satisfy yourself that, in fact, none of the complexities apply – e.g. there were no chargeable transfers in the seven years prior to the settlement, there were no related settlements, there has been no addition of property, there were no capital distributions, none of the property has become relevant property over the last ten years etc. On most occasions, none of these are factors and the calculations wind up being at the more straightforward end of the scale. However it involves time (and cost!) to confirm that is the case, which can be all the more galling when the charge itself ends up being insignificant.

The final problem is then of course trying to explain to the client why the chargeable costs exceed the tax itself!