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IHT Basics

Ruth Hughes and Arabella Adams

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In this world nothing can be said to be certain, except death and taxes – Benjamin Franklin

- A talk of two halves
  - First half will deal with IHT on death; and
  - Second half will deal with PETs and IHT in the context of trusts

IHT on death estate

It is overly simplistic to divide IHT into IHT on death and IHT on trusts

Tax may be charged – if there is a chargeable transfer of value

(i) An immediately chargeable transfer (either at lifetime rates) or on death

(ii) On a potentially exempt transfer (more about that later)

(iii) Exempt

What is a chargeable transfer

Section 2(1) of the Inheritance Tax Act 1984

> *“any transfer of value which is made to an individual but is not ... an exempt transfer”*

A transfer of value – loss to the donor principle

Section 3(1) IHTA 1984

> *"a disposition made by a person ... As a result of which the value of his estate immediately after the transfer is less that it would be but for the disposition"*

No account is taken of excluded property, see section 6

- remainder interest under trusts (section 48)
- Non-UK situs property of a non-dom for IHT purposes

Failure to exercise right cases – *Staveley* SC decision awaited

Transfer of value on death

- On death a deceased person is treated as if he had made a transfer of value immediately before his death the value of which is equal to the value of his estate immediately before death – section 4(1)

Estate

The estate for these purposes is the aggregate of all the property to which a deceased person is beneficially entitled immediately before death (section 5(1))

- apart from certain types of interest in possession; and
- excluded property (section 5(1)(a))

Liabilities of the estate are generally deducted provided full consideration was given.

- "artificial debts" – section 103 Finance Act 1986
- see also Finance Act 2013 – in relation to exempt property

Estate #2

A person’s estate therefore includes

- Settled property where the Deceased has a qualifying interest in possession – (section 49(1)) ... More on that later...

- Property in which he has reserved a benefit – section 102(2) and (3) of the Finance Act 1986

  - Trap – pre-owned asset tax! Sch 15 to the Finance Act 2005

Charge on death

Add together all the property previously mentioned

- Valuation – open market value, section 160
- The value of business and agricultural property may be reduced by 100% or 50% for BPR and APR (inc woodlands)
- Deduct nil-rate band (£325,000)
  - Transferable nil-rate band between spouses – section 8A
  - Residential nil-rate band – section 8D –there be dragons!

Main exemptions

- Spouse exemption - section 18 (more limited if spouse is non-dom –nil rate band)
- Charity (section 23)
- Annual - £3,000 (section 19)
- Small gift - £250 (section 20)
- Gifts out of surplus income (section 21)
- In consideration of marriage (section 22)
- Political parties (section 24)

Deemed Domicile IHT

- From 6 April 2017 the following rules for IHT deemed domicile apply:

- (1) – 15 out of 20 years – the Deceased can be deemed domiciled even if non-resident
- (2) – formerly domiciled in the UK and are resident for at least 1 of the two previous tax years
- Also note – Double Tax Treaties, may prefer actual domicile to deemed domicile

Post-death re-arrangement

- Quick succession relief (section 141)
- Deed of Variation (section 142)
  - May need a VTA
- Compliance with request (section 143)
- Appointment (under section 144)
- Claim under the Inheritance Act 1975 (section 146)

Potentially exempt transfers (PETs)

- Transfers of value in the may be:
- Exempt transfers
- Chargeable transfers
- Potentially exempt transfers: may become exempt or may become chargeable

PETs operate only in the context of lifetime dispositions

Note existence of the Inheritance Tax (Double Charges Relief) Regulations 1987

What are PETs? (1)

- Section 3A(1A) IHTA: a PET is a transfer of value:
- made by an individual;
- which, apart from this section, would be chargeable transfer;
- to the extent it constitutes a gift to another person or a gift into a disabled trust [but not gift into or creation of any other form of trust *i.e.* save for a gift into a disabled trust it must be an absolute, not settled, gift]

Section 3A(4): a PET made 7 years before the death of the transferor is an exempt transfer; any other PET is a chargeable transfer

What are PETs? (2)

- What happens in the interim period?
- Section 3A(5): During the period beginning on the date of the transfer and ending immediately before—
- (a) the seventh anniversary of that date; and
- (b) if earlier, the death of the transferor
- it shall be assumed that the transfer will prove to be an exempt transfer.
- Therefore, no charge is (initially) incurred at time of transfer

Lifetime chargeable transfers (1)

- Lifetime chargeable transfers (*e.g.* gifts into trust) give rise to an immediate charge to tax.
- What is the rate of tax?
- Nil-rate band (currently £325,000)
- Above that threshold, tax charged at 20% (lifetime) or 40% (death)
- Availability of nil-rate band depends on cumulative chargeable transfers in previous 7 years

Lifetime chargeable transfers (2)

- Example (assuming NRB is £325,000 at all relevant times):
- Year 1: Rishi has made no chargeable transfers in previous 7 years; settles £300,000 on trust; no IHT payable because whole of gift is within NRB
- Year 6: Rishi makes a further gift of £300,000 into trust; available NRB is £25,000; remainder of gift incurs charge to tax of £275,000 x 20% = £55,000

- In effect, cumulative chargeable transfers up to the NRB may be made every 7 years without incurring charge to tax

"Failed PETs"

- "Failed PETS" = PETs that become chargeable transfers by reason of the death of the transferor
- No charge to tax at time of transfer (unlike immediately chargeable transfers)
- Failed PET becomes taxable as if it had been a chargeable transfer at the time of transfer (*i.e.* based on available NRB at the time of transfer)
- Charge in respect of subsequent chargeable transfers may need to be re-calculated to take account of any utilisation of the NRB in respect of the earlier failed PET

Re-calculation following failed PET

- Assume Rishi has full NRB of £325,000 available
- Year 1: Rishi makes PET of £400,000; no charge to tax
- Year 2: Rishi makes chargeable transfer of £325,000; no charge to tax because of available NRB
- Year 3: Rishi dies; PET fails and becomes chargeable, utilising whole of NRB; also, tax in respect of year 2 needs to be re-calculated to reflect fact that there is no available NRB (because of failed PET in excess of £325,000 within previous 7 years)

Settlements and settled property

- Section 43 IHTA: "Settlement" means any disposition whereby property is for the time being:

- Held in trust for persons in succession or subject to a contingency [*e.g.* life interest trust]
- Held by trustees on trust to accumulate income or with power to make payments out of income at their (or another's) discretion [*e.g.* discretionary trust]
- Charged with an annuity payable for a life or other limited or terminable period

"Settled property" construed accordingly

Taxation of trusts: pre-22 March 2006

- Key distinction:
- interest in possession (IIP)
- non-IIP (*e.g.* discretionary trust)

- IIP trusts: effectively taxed as if the life tenant was the beneficial owner of the settled property in which the IIP subsists, *i.e.* settled property effectively formed part of
- Non-IIP trusts: taxed in accordance with “relevant property” regime – more later

Taxation of IIP trusts (pre-22 March 2006)

- Settled property treated as forming part of the life tenant's estate for IHT (and creation of IIP trust was a PET rather than chargeable transfer)
- No lifetime charges during continuation of the IIP
- If IIP came to an end during lifetime of life tenant, treated as making a transfer of value equal to value of settled property (PET or chargeable transfer depending on destination)
- Conversion of IIP into absolute interest (*e.g.* appointment out to life tenant): IHT neutral because no diminution in life tenant's estate
- Settled property aggregated with life tenant's free property for purposes of calculating charge on death
- Conclusion: Relatively benign tax treatment

Relevant property regime

- Section 58 IHTA: "relevant property" means (slightly simplifying) settled property in which no qualifying IIP subsists
- Pre-22 March 2006, almost all IIPs (whether testamentary or created *inter vivos*) were "qualifying" IIPs and, hence, outside relevant property regime
- Therefore, relevant property regime covered, typically, discretionary trusts (and often colloquially called "discretionary trust regime")

Taxation of relevant property (1)

- Two occasions of charge:
- Charge on ten-yearly anniversaries of commencement of settlement (“ten-yearly charge”; “decennial charge”; “periodic charge”)
- Charge on property ceasing to be relevant property (“exit charge”)

Unlike IIP trusts, charges arose during lifetime of trust and would always arise upon *e.g.* appointments out

Taxation of relevant property (2)

- Charge to tax:
- Tax charged on value of relevant property at date of occasion of charge
- Complicated process for calculating rate of tax
- Based on settlor's available NRB immediately before creation of settlement
- Maximum effective rate = 6%
- Exit charges calculated as a fraction of effective rate depending upon number of three-month periods since commencement or previous 10-year anniversary

The 2006 Budget

- 2006 Budget contained substantial amendments to taxation of trusts
- Purpose of Government appears to have been to make trusts a less attractive vehicle for wealth holding
- Basic approach: reduce the number of qualifying IIPs and, hence, ensure more trusts fell within the relevant property regime
- Prospective in effect: IIPs in existence pre-22 March 2006 (Budget day) retain their old characteristics (but not new IIPs in pre-2006 trusts

Effect of 2006 changes

- IIP trusts generally less attractive:
- Creation *inter vivos* of new trusts (or addition to existing trusts, even pre-2006 trusts) usually a chargeable transfer rather than a PET
- IIP trusts generally now suffer periodic and exit charges which were previously limited to discretionary trusts
- BUT death of post-2006 life tenant no longer gives rise to a tax charge if property remains settled

Qualifying interests in possession post-2006

- A post-2006 IIP is a qualifying IIP (and, hence, not relevant property) only if it is:
- Immediate post-death interest (IPDI)
- Disabled person's interest (DPI)
- Transitional serial interest (TSI)

Immediate post-death interests

- As the name suggests, an IPDI
- Must be created by will (or intestacy)
- Beneficiary must become entitled to IIP immediately upon the death of testator/intestate

Transitional serial interests

- Where a pre-22 March 2006 IIP came to and end and was replaced by a new IIP in the same property before 5 October 2008, the "new" IIP was a TSI and, hence, a qualifying IIP

- Since 6 October 2008, the "new" IIP is a TSI only if:
- "old" IIP came to an end on the death of the "old" beneficiary; and
- "new" beneficiary was wife or civil partner of "old" beneficiary immediately before death

Favored Regimes

- Trusts not taxed under the relevant property regime

- Bereaved minor trusts, including those which arise under intestacy
- Section 71 D Trusts (18 – 25)
  - Common to apply for a VTA

Incidence and Burden of IHT

- Sections 199 to 214 of the Inheritance Tax Act
- The transferor
- The PRs
- The transferee
- The trustees
- The person in whom the property is or has been vested beneficially or otherwise
- The beneficiaries

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any questions please email Marketing@5sblaw.com

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