

HMRC has proposed changes to the way in which inheritance tax charges on trusts are calculated.

If enacted, the proposals will effectively mean an end to 'pilot trusts' (see below) and anyone who has established pilot trusts should review their planning. The proposed changes will impact on trustees, settlors and beneficiaries of trusts which are subject to UK inheritance tax, including trusts set up by non-UK domiciled settlors which hold UK assets.

The proposed changes would apply to all trusts (not just new trusts) from a specified date, likely to be at some point in 2014.

Background

Many trusts are subject to an IHT charge:

- on every 10 year anniversary of the date the trust was established; and
- when distributions are made to beneficiaries, or the trust is wound up.

It is widely accepted that the current regime for calculating these tax charges is complex and the costs involved in collecting the necessary information and doing the calculations, particularly for smaller trusts, can be disproportionately large compared to the tax at stake.

Under the current rules, to calculate the IHT due, the trustees need to have information on the historic value of the trust's assets, and assets placed into other trusts by the settlor on the same day, as well as details of any gifts made by the settlor in the seven years before the trust was set up.

Proposals for simplification

In an attempt to simplify matters, HMRC has proposed a number of changes to the way in which IHT charges on trusts are calculated.

1. **The nil rate band should be split between all trusts which a settlor has made**

HMRC proposes that the amount of the nil rate band (NRB) available to a trust should not be calculated, as currently, by looking at the lifetime gifts made by the settlor in the seven years before a trust was set up. Instead, the NRB should be split between all trusts which the settlor has made.

What does this mean?

This will effectively mean an end to 'pilot trusts' and will impact on anyone who has set up pilot trusts with the intention that those trusts will receive assets from their estate following their death.

Currently, lifetime gifts made by a settlor in the seven years before (i) he set up the trust or (ii) additional assets are added to the trust, are taken into account in determining the amount of the NRB which is available to a trust. The NRB is the amount which, on the occasion of a charge to IHT, is charged to tax at 0%. The NRB is currently £325,000.

How pilot trusts currently work: example

James set up seven separate discretionary trusts in June 2008 (Trust 1, Trust 2, Trust 3 etc.). Each trust was set up on a separate day with a nominal sum of £100 and so each trust has its own NRB. James had not made any lifetime gifts prior to June 2008.

James dies in May 2013 with an estate worth £1.4m. He made no lifetime transfers in the seven years before his death. His will leaves a one-seventh share of his estate to each of the pilot trusts set up in June 2008. Leaving his estate to the seven pilot trusts does not reduce the charge to IHT on James' death but no charge to IHT should arise on the 10 year anniversaries of the trusts or when assets leave the trusts as the amount in each trust is less than the relevant NRB.

Impact of proposals on pilot trusts

Under the proposals, each time one of the trusts is subject to a charge to IHT, the NRB will be split between all the trusts of which James is the settlor and which are in existence at any time during a set period before the date of the tax charge.

For example, on the first 10 year anniversary charge to IHT on Trust 1 the NRB will be split between all the trusts of which James is the settlor and which are in existence at some point in the 10 years between the date Trust 1 was established and the date of the 10 year charge.

At the time of the first 10 year charge after James' death, Trust 1 (which now holds £200,000) will, therefore, have a NRB allowance of only about £46,500 meaning that around £150,000 will potentially be exposed to IHT. Under the current rules Trust 1 would have its own full NRB and so there would be no charge to IHT at this time.

There is no suggestion in the consultation paper that the NRB will be pro-rated to take into account the value of each trust fund. So if James, in the example above, created a further trust during his lifetime with £200,000, each of the seven pilot trusts (which hold just £100) and the trust with £200,000 in would be entitled to an equal amount of the NRB – £40,625 of the NRB. Most of the NRB allocated to each of the seven pilot trusts will not be used during James' lifetime, whereas the trust containing £200,000 will have more than £150,000 potentially subject to IHT.

If the proposals are enacted, trustees will need to know of all trusts established by the same settlor, which are in existence, at any time, in a maximum of a 10 year period, in order to calculate the IHT charges on the trust. This could prove difficult to ascertain.

2. **Assets which are not subject to IHT should be ignored**

HMRC proposes that the value of any assets in the trust which are not subject to the IHT charge – for example, excluded property – should be ignored for the purposes of the IHT calculations.

What does this mean?

This will impact on trusts set up by non-UK domiciled individuals, which hold both UK and non-UK assets.

If an individual sets up and funds a trust when he is not domiciled (and not deemed domiciled) in the UK no UK IHT will be payable on the non-UK assets in the trust. Only the UK assets in the trust will be subject to the 10 yearly IHT charges and IHT when they are distributed out of the trust. The non-UK assets are excluded property – that is, they are excluded from UK IHT.

Under the current rules, the value of non-UK assets in the trust is taken into account in calculating the IHT charges on the UK assets. Ignoring the value of the non-UK assets in such trusts will simplify the calculations and should ensure that any available NRB reduces the value of the UK assets subject to IHT.

3. **IHT should be charged at a flat rate of 6%**

Currently, IHT is charged at a maximum rate of 6% on each 10 year anniversary of the date a trust was established, and when distributions are made to beneficiaries. The exact rate is determined by a complicated calculation but in many cases is significantly below 6%.

HMRC is proposing to simplify matters by introducing a flat rate of 6%. This change will lead to a higher tax charge in some cases.

4. **Income should be treated as accumulated after a set period**

Income which arises to a trust is only taken into account in calculating the IHT charges once it has been accumulated and added to the capital of the trust. Where trustees neither distribute income, nor formally accumulate it, it is unclear at what point it should be treated as added to the capital of the trust.

HMRC proposes that income which is not distributed should be added to the capital of the trust at the start of the second tax year after the end of the tax year in which it is received. Once income is added to the capital of the trust it is taken into account in calculating the IHT charges.

This note is a general guide based on the proposals as at 24 June 2013. It is intended to provide a brief overview only and should not be relied on as legal or tax advice. Specific advice on the particular facts of any matter should be sought.