PHOENIX WEALTH

TECHNICAL BRIEFING

2016/2

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Calculating and Reporting IHT Periodic Charges

Key Points

- Ten years after the changes to the relevant property regime in 2006, trustees will shortly need to assess whether a charge to inheritance tax (IHT) is due in respect of policies written subject to discretionary trusts issued post 21 March 2006.
- This Technical Briefing explains the ten yearly periodic charge which could be applicable to such policies. It also clarifies the reporting requirements for trustees and what information they will need and looks at what Phoenix Wealth will be doing to support settlors, trustees and advisers in this process.

The Finance Act 2006

Prior to 21 March 2006, when a life policy was placed into trust, the trust that was almost always used was an Interest in Possession (IIP) trust.

An IIP trust is also referred to as a flexible power of appointment trust and, like a fully discretionary trust, allows the trustees flexibility regarding the payment of both income and/or capital to the potential beneficiaries under the trust. However, unlike a discretionary trust, the IIP trust provided that the value of the trust property was deemed to form part of the estate of the person(s) who held the IIP until the point that interest was appointed away from them, at which time a transfer of value for IHT purposes was made. The creation of this type of trust was also treated as a potentially exempt transfer by the settlor for IHT purposes.

However, the Finance Act 2006 introduced legislation that meant that, with a few limited exceptions, new IIP trusts created post 21 March 2006 would be subject to the relevant property regime which had previously only applied to true discretionary trusts.

The Relevant Property Regime

The relevant property regime seeks to apply IHT charges to the trust instead of any individual, in the form of potential entry, exit and ten yearly periodic charges. This is to accommodate the fact that the trust property is not part of the estate of any individual beneficiary. In essence, the regime means that trustees, rather than individuals, are taxed at certain points based on the value of the trust assets at the time. Furthermore, the relevant property regime removes the necessity to track changes in beneficial rights for IHT purposes - which was required under the old IIP regime.

Finance Act 2006 also potentially brought pre 22 March 2006 IIP trusts into the relevant property regime if certain changes were made to these trusts, including changes to the IIP beneficiary. The rules here can be quite complex and this Briefing does not, therefore, deal with this area.

Now that we are into 2016, the first ten yearly anniversaries on any discretionary trust established post 21 March 2006 are approaching and periodic charges will potentially become reportable and tax may be payable. The policies affected will be all Phoenix Wealth Investment Bonds that have been written subject to a discretionary trust as well as discounted gift trusts and loan trusts where a discretionary trust has been used.

It is the ten yearly periodic charges that are the focus of the Briefing.

When does a trust become reportable?

Under the terms of The Inheritance Tax (Delivery of Accounts Excepted Settlements) Regulations 2008, if the value of the trust fund is over 80% of the Nil Rate Band (NRB) (which equates to £260,000 where the NRB is £325,000), then the trust must be reported to HM Revenue & Customs (HMRC).

This £260,000 threshold is designed to allow HMRC to receive information on trusts where the value of the trust at the time of the ten yearly anniversary falls just below the taxable threshold. This in turn enables HMRC to potentially query valuation issues with the trustees, which would otherwise be unknown if the reporting threshold was set at the full NRB (£325,000 until tax year 2020/21).

It is important to understand that some trusts may therefore be reportable but no tax will actually be due on that trust as the value of the trust is below the NRB.

Under what conditions will a ten yearly periodic charge actually become payable?

A ten yearly periodic charge will actually be due if the value of the trust fund exceeds the NRB at the 10 year anniversary date. The excess over the NRB at that time is then taxed at 6%. What follows now is an outline of how this would work in respect of different situations.

Simple gift trusts

For gift trusts, the trustees or their adviser will simply need to understand what the value of the policy is at the date of the 10 year anniversary. They will also need to take into account any chargeable lifetime transfers made by the settlor in the period of seven years prior to setting up the gift trust, and any withdrawals that have been taken from the policy and distributed to beneficiaries during the ten year period. Broadly, if the value of the policy plus any withdrawals is above £325,000 tax will be payable. The tax should be paid by the trustees. They will be able to do so by accessing withdrawals from the policy. Any withdrawals taken by the trustees to pay the tax will count towards the 5% p.a. entitlements, and if withdrawals from the policy exceed the 5% p.a. entitlements, a chargeable event will occur for income tax purposes.

Loan trusts

The situation for loan trusts is the same as that for gift trusts except that, in order to calculate the value of the trust property, the trustees need to deduct the value of the outstanding loan owed to the settlor at the ten yearly anniversary from the value of the policy. Withdrawals taken from the policy to pay back part of the loan can be ignored. Again, the tax should be paid by the trustees as they will be able to access withdrawals from the policy.

Discounted Gift Trust

If the settlor is dead at the date of the ten yearly anniversary then the situation is the same as for gift trusts. Any withdrawals taken from the policy and paid to the settlor during the settlor's lifetime can be ignored but any withdrawals taken by the trustees and distributed to beneficiaries since the settlor's death need to be taken into account in addition to the actual policy value.

If the settlor is still alive at the ten yearly anniversary then the position is slightly more complicated. Once again, it is necessary to determine the value of the bond at the anniversary date. Any withdrawals taken from the policy can be ignored. However, the value of the trust fund is able to be reduced by the value of the settlor's right to future withdrawals for the rest of his or her lifetime. In other words, a revised discount will apply at that time. HMRC have confirmed that a simplistic valuation approach is permissible in these circumstances, meaning that the discount will be based on the addition of ten years to the settlor's age or rated age at the outset of the policy.

For many clients that hold a Discounted Gift Trust, a periodic charge in 2016 is unlikely to be payable for trusts created post 21 March 2006 for several reasons:	
	1. Any discretionary discounted gift trust created since 21 March 2006 is likely to have had an initial gift value that was equal to, or less than, the NRB at the date of commencement in order to avoid an immediate charge to tax. The NRB has slightly increased since 6 April 2006 from £285,000 to £325,000, giving each trust an extra £40,000 of growth before any ten yearly periodic charge is relevant.
	2. As stated above, the settlor's rights to future withdrawals need to be valued at the point of the periodic charge, thus reducing the value of the trust for the purposes of reporting and paying tax. Furthermore, a discount will still apply in this situation even if the addition of ten years to his or her age next birthday means that the settlor is aged over 90 at the ten year anniversary. This difference in approach to 'over 90' ratings is mainly due to the fact the valuation is based on the open market value of the remaining trust fund, and any buyer of the beneficiary's rights would need to take into account the fact that he or she would not be able to access the funds until the death of the settlor.
	3. Under the Discounted Gift Trust, the settlor will usually have taken withdrawals utilising the full 5% p.a. tax deferred allowance to maximise the value of their discount. These withdrawals, together with charges on the underlying policy, will have an impact on the net growth meaning it is less likely for the growth under the policy to have exceeded the £325,000 NRB.

An example may help to demonstrate these points:

- Sandra invested £600,000 into a Discounted Gift Trust on 1 July 2006
- At that time, she decided to take 5% p.a. tax deferred withdrawals on a monthly basis which equate to £2,500 per month
- This resulted in a discount on 1 July 2006 of £356,000 and a corresponding gift of £244,000. As the NRB at the date of commencement of the policy was £285,000 there was no entry charge
- At the time of investment Sandra was aged 66 next birthday. For underwriting purposes, 2 years were added to her age giving her a 'rated age', for the purposes of calculating the discount, of 68 next birthday.

Position at the ten year anniversary on 1 July 2016:

The value of the policy is now £586,110.

Sandra is still alive on 1 July 2016 and her effective age, for the purposes of calculating the revised discount is obtained by adding 10 years to her "rated age", making her 78 next birthday.

The discount applicable for a 78 year old is £250,652 (Note this discount will be calculated using the methodology and actuarial tables currently in force).

Therefore, the value of the trust fund is £586,110 - £250,652 = **£335,458**
Value over the NRB on 1 July 2016 = **£10,458**
Tax to pay @ 6% = **£627**

As there will be tax to pay at the ten yearly anniversary, this means that any future payments out of the trust for the following ten years (other than payments to the settlor) would also attract a tax charge. This charge would be based on the effective rate at the ten yearly anniversary which would be calculated as follows:

£10,458 @ 20% = £2,091.60. £2,091.60/£335,458 = 0.623505% @ 30% = **0.18705%**

The effective rate is therefore **0.18705%** and the actual tax calculation on any future payments out of the trust for the following ten years will use this rate. The tax payable would be based on the number of complete quarters since the last ten yearly periodic charge was due to give a proportional tax charge. It is emphasised that withdrawals paid to the settlor would not be relevant for these purposes.

How can you calculate if the trustees will need to report or pay tax?

The following table provides an overview of the actions that should be taken by trustees to check the reporting and the taxable position of the trust. These actions are mainly based on the value of the trust fund at the time of the periodic charge:

Value at the ten year anniversary*	Action to take
£0 - £260,000	• No action to take, trust fund less than 80% of NRB.
£260,000 - £325,000	• If this is a standard discretionary trust then the trust will be reportable. • If the trust is a Discounted Gift Trust then the trustees should contact Phoenix to find out whether the discount takes the policy under the reporting threshold.
Exceeds £325,000	• If this is a standard discretionary trust then the trust will be reportable and a periodic tax charge will apply. • If the trust is a Discounted Gift Trust then the trustees should contact Phoenix to find out whether a discount takes the policy out of a tax charge and/or under the reporting threshold.

*Values can be doubled in cases where there were joint settlors. For discounted gift trusts, this value will be the value less any relevant discount at this time.

When must the report be submitted and the tax paid?

Trustees must report and have paid IHT by the end of the sixth month after the date in which the ten yearly periodic charge occurred. HMRC will charge interest on payments received after the due date.

What forms must be completed and where must these be sent?

To report the ten yearly periodic charge, the HMRC form **IHT100** should be used if the value of the trust exceeds 80% of the NRB. If a tax charge is applicable then the additional form **IHT100d** must also be submitted, which is specifically used to declare and pay the ten year periodic charge.

The forms must be returned to HMRC and more information on the returns can be found on the following link:

www.gov.uk/government/publications/inheritance-tax-inheritance-tax-account-iht100

Payment of any periodic charge under the Discounted Gift Trust during the settlor's lifetime

Under the Discounted Gift Trust, the settlor has rights to the fixed withdrawal payments during their lifetime. It is not possible to withdraw any additional money from the trust, and so the trustees cannot access the policy to pay any IHT liability that may arise at the ten yearly anniversary. Ultimately, this will mean that whilst the trustees must file the report with HMRC, the settlor may have to pay any tax due. As the settlor would be discharging a liability of the trustees, this would constitute a transfer of value by the settlor for IHT purposes but the £3,000 annual exemption may be available in these circumstances.

Where a Discounted Gift Trust is still in force and the settlor is dead, the trustees can, of course, take withdrawals or surrender segments to pay any potential ten yearly periodic charge.

What will Phoenix Wealth be doing to assist trust reporting?

Certificate of Valuation	At the commencement of a Discounted Gift Trust, settlors are provided with a certificate of valuation showing the discount given. A similar document can be provided to the trustees on request at the time of the ten yearly anniversary. This certificate will show the value of the settlor's future rights to the selected level of withdrawals at the ten yearly anniversary and, along with a current valuation of the policy, will allow the trustees to calculate the tax position. The trustees can then use this certificate if reporting to HMRC using forms IHT100 and IHT100d.
Other discretionary trusts	As we have seen, many factors contribute to the fact that a ten yearly periodic charge being payable on a Discounted Gift Trust is unlikely. Conversely, where a discretionary trust is utilised in conjunction with an Investment Bond there will be no discount and possibly no withdrawals. This could make reporting more likely for such policies that were set up post 21 March 2006. However, the issue here is relatively straightforward and simply requires the trustees to understand the value of the policy at the time of the ten yearly periodic charge. All the relevant information is available to trustees and advisers without further calculations being necessary. Phoenix Wealth do not intend to provide any additional guidance or assistance in this area.

Conclusion

The requirement to report and potentially pay tax on discretionary trusts could create an additional administrative burden on trustees and advisers post 21 March 2016 and beyond. However, many Discounted Gift Trusts will be free from reporting and any actual tax liability for the reasons described earlier.

Where necessary Phoenix Wealth will be providing the assistance necessary in order to help trustees to understand their position and take the relevant action.

In all cases, the first step to take should be to obtain a valuation of the policy. Once this has been obtained and assessed against the table contained in this Briefing, the appropriate course of action should be followed.

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