

Entry & Supplementary Charges

This technical note provides an overview of potential charges payable on entry of assets into relevant property trusts and what the IHT position might look like on the death of the settlor whilst there are still gifts 'on the clock'.

Since 22nd March 2006, almost all trusts created during the Settlor's lifetime are classified as Relevant Property trusts for taxation purposes.

Due to the fact that the assets within a relevant property trust generally do not amalgamate with the estate of any individual beneficiary, HMRC seeks to apply Inheritance Tax ('IHT') charges to such trusts in the form of potential entry, periodic and exit charges.

In other words, HMRC could lose out on IHT on the death of an individual if assets are held within a relevant property trust, particularly if the trust is non-settlor interested for IHT purposes and it is for this reason that these trusts are subject to IHT charges.

As stated above, since 22nd March 2006, almost all lifetime trusts created will be relevant property trusts and as such, any transfer of assets into such a trust will be potentially subject to an entry charge.

Entry charges are payable at a rate of 20% (half the death rate) on the excess of the settlor's available Nil Rate Band ('NRB') and after the application of all relevant reliefs and exemptions.

In short, provided you settle within the available NRB, then there will not be an immediate tax charge.

Key Learning Points

1. Chargeable Lifetime Transfers
2. What about loans?
3. Clawback of Business Property Relief and Agricultural Property Relief
4. Supplementary Charge
5. The '14 year rule'
6. Probate Trust v Gift Trust
7. Summary

Chargeable Lifetime Transfers

It is crucial to know that since 22nd March 2006, any lifetime settlement into trust (unless the trust is either a vulnerable persons trust or a bare trust) is treated as a Chargeable Lifetime Transfer ('CLT').

Further, it is only CLT's that are potentially subject to an entry charge.

If after the application of any available reliefs and exemptions, the value of a CLT exceeds the settlor's available NRB, the excess will be subject to IHT payable at a rate of 20%.

Importantly, any Potentially Exempt Transfers ('PET') made prior to a CLT are not taken into account for the purposes of calculating the available NRB.

Example 1:

Andrew made a gift of £150,000 to his brother William on 5th May 2019 and he also transferred £113,000 into a gift trust on 10th June 2020 and an additional £300,000 into the same trust on 1st January 2021.

Andrew did not make any other gifts within the previous 7 years.

Calculation of Inheritance Tax/Entry Charge on transfer of assets into discretionary trust by Andrew:

- Andrew made his first gift into trust on 10th June 2020. His available NRB at that time was £325,000 as the previous gift made to his brother was a PET and thus not at this point chargeable. This means that his first gift into trust did not exceed his available NRB, therefore no IHT was charged on that transfer.
- The second gift into trust was made on 1st January 2021. Andrew's available NRB on that date was already reduced by his previous gift made on 10th June 2020 by £110,000 (£113,000 minus £3,000 annual allowance for 2020/2021).
- In other words, on 1st January 2021, Andrew's available NRB was £215,000 so his second gift into trust exceeded it by £85,000 and the entry charge payable on this transfer is £17,000 (£85,000 x 20%).

Example 2:

John transfers his shares in an unquoted company which qualifies for 100% Business Relief ('BR') into a discretionary trust. The value of the shares at the point of transfer is £1,000,000.

There is no entry charge on this transfer by virtue of the BR exemption that applies to the assets being gifted into the discretionary trust.

What about Loans?

Noting all of the comments above about the effect of a CLT and the potential entry charge where the available NRB has been breached, it is important to understand that a CLT only applies where there is a 'gift' to a relevant property trust.

It is possible to loan funds to a trust and this would not be deemed as a CLT, this is due to the neutral effect for IHT purposes, the value of the loan will remain part of the estate of the settlor and the trustees owe a debt to the settlor, so at the point of the funds going into the trust, the IHT position has not changed.

There may not therefore be a perceived benefit to this course of action, however consider a wealthy client who is in a position whereby any growth in the value of his estate is increasing his IHT liability, this means that for every £1 of growth, potentially 40p is going to become payable in IHT on death.

So, if a client has already fully utilised their NRB and wants to transfer more assets into a trust, but do not want to breach their NRB for want of avoiding an immediate 20% tax charge, then they could loan the remainder and that money could be invested within the realms of the trust.

Critically, provided the trust is a gift trust, the growth in investment value would be immediately outside of the estate for IHT purposes.

Clawback of Business Relief and Agricultural Relief

As illustrated in Example 2 above, where a gift into a relevant property trust consists of assets qualifying for BR or AR, the lifetime transfer rate can be reduced (to nil or by 50%). However, both reliefs can be clawed back if the transferor dies within seven years of the transfer into a trust.

The clawback will not apply as long as the following conditions are met:

- Trustees own the original qualifying property for the whole period from the date of the gift through to the date of death of the Settlor. In some circumstances, the clawback will not apply if the original property was replaced with qualifying assets.
- The property (or replacement property) still qualifies for BR or AR but ignoring the two-year ownership period.

Note that when the clawback operates, the increase of IHT will only affect the amount of tax payable by the Trustees. The NRB available to the settlor's estate will not be reduced.

This means that where clawback operates, it is much more beneficial if the original gift was CLT instead of Potentially Exempt Transfer (PET), see example below:

Example 3:

Paul transfers his fully BR relievable shares worth £250,000 into the names of the trustees of a non-settlor interested gift trust on 25th April 2016. 3 years later, the trustees sell the shares and utilise all of the proceeds towards the purchase of a new residential property.

Paul passes away on 1st January 2020 leaving his entire estate of £300,000 to his best friend Anna. The trust fund at the date of Paul's death is worth £400,000. What IHT consequences arise from Paul's death?

- There was no entry charge payable on the transfer of the shares into the trust on 25th April 2016 as all of the shares were eligible for 100% BR. However, Paul died within 7 years from the date of the transfer and the trustees sold all of the shares without replacing them with BR assets, so the clawback provisions must be considered.
- It is important to note that the value of the BR shares at the date of transfer into the trust were worth £250,000 which is £75,000 less than the NRB available at Paul's date of death (annual allowance not included in the calculation). This means that there is no additional IHT due by the trustees.
- In addition, the NRB available to the estate of the late Paul is still £325,000. Had Paul made his gift of BR shares to an individual (PET) instead of a trust, the NRB available to his estate on death would only be £100,000 as the failed PET would utilise his NRB first.

Supplementary Charge

When a settlor passes away within 7 years from making a gift in excess of his available NRB into a discretionary trust which he was not a beneficiary of, a supplementary charge of 20% applies (the balance due to the death rate of 40%).

Example 1:

Anna died on 15 March 2016. She was a divorcee when she died. Anna made a gift of £506,000 into a discretionary trust on 10th March 2012. Sarah hadn't made any previous gifts in the 7 years prior to the transfer.

Calculation of Supplementary Charge in relation to Anna's gift into trust on her death:

- The starting point will be to calculate the amount of entry charge payable on 10th March 2012. Anna's available NRB at that time was £325,000.
- From that, you can take your annual exemption for the tax year of the gift and the tax year prior to that provided that wasn't used, so that's £6,000 off the gift.
- This means that £175,000 was taxed at the rate of 20% resulting in £35,000 entry charge.
- Anna died within 7 years from making her gift and thus the gifted amount is still 'on the clock' for IHT purposes.
- Anna will have a credit for the tax already paid, i.e. the 20% entry charge already accounted for, but there will now be the additional 20% to be paid.
- Due to the fact that the gift was made between 4 & 5 years prior to Anna's death, taper relief will apply such that only 60% of the additional tax will be payable and thus;
- $£35,000 \times 60\% = £21,000$ further IHT to be paid.

The '14 year rule'

When calculating IHT payable as a result of somebody's death, their executors will need to investigate any failed PETs and CLTs made by the deceased within 7 years before their death.

However, where a CLT was made in the 7 years before a PET which has failed, that CLT will still be taken into account to calculate if tax is payable on a failed PET even if that means that the CLT was actually made more than 7 years prior to the passing away of the person who made the gift.

This is because the NRB will be used by the CLT first and this can result in more IHT being payable on the failed PET than initially expected.

Example 4:

Paula died in 2021. She was single when she died. Paula made a gift of £200,000 into a discretionary trust in 2013. She also made a gift of £200,000 to her sister in 2019.

Paula was not entitled to any exemptions or reliefs at the time of making her gifts.

- Paula's first gift into the discretionary trust was a CLT but it was below her available NRB, therefore an entry charge did not apply.
- The second gift made to Paula's sister was a PET which failed as Paula did not survive 7 years from making it.
- Despite Paula's gift into discretionary trust being made more than 7 years prior to her date of death, it still reduces the NRB which can be offset against her failed PET made in 2019.
- The supplementary charge on the failed PET will be calculated as follows:
 - o £200,000 (CLT) + £200,000 (failed PET) = £400,000 (cumulative total)
 - o £400,000 (cumulative total) - £325,000 (NRB) = £75,000 (chargeable amount)
 - o £75,000 (chargeable amount) @ 40% (IHT rate) = £30,000 (tax due by donee)
 - o As the PET was made within 3 years of the death of Paula, there will be no taper relief available

Note that the 14 year rule only applies to failed PET's and not failed CLT's, therefore, if the gifts in this example were the other way round, there would not have been an adjustment required.

Probate Trusts v Gift Trusts

As explained, entry charges limit the amount that can be gifted 'tax free' into a lifetime trust to the available NRB in any given 7 year period and this applies irrespective of whether or not a trust is a settlor interested trust (meaning there will be no reduction in estate value for IHT purposes) or a non-settlor interested trust (which potentially benefit from a reduction in estate value).

A trust will be settlor interested for IHT purposes if the settlor is able to benefit from it.

If your client wishes to protect assets during their lifetime and is not concerned with IHT, then our Probate Trusts provide a solution to the limit imposed by entry charges. Our Probate Trusts have been specifically designed to enable them to receive unlimited assets during the lifetime of the settlor without incurring any trust IHT charges.

However, the trust fund will amalgamate with the value of the settlor's estate on death meaning it will be assessable to IHT at that stage. Thus our probate trusts should be seen as neutral from an IHT point of view.

Summary

- Since 22nd March 2006, any lifetime settlement (unless the trust is a vulnerable person's trust or a bare trust) will be treated as a CLT.
- If after the application of the available reliefs and exemptions the value of a CLT exceeds the settlor's available NRB, the excess attracts IHT payable at a rate of 20%.
- Where a gift into relevant property trust consists of assets qualifying for BR or AR, the lifetime transfer rate can be reduced (to nil or by 50%). However, both reliefs can be clawed back if the transferor dies within seven years of the transfer of assets into trust.
- When the settlor passes away within 7 years from making a gift in excess of their available NRB into a gift trust, a supplementary charge of 20% applies (the balance due to match the death rate of 40%).
- Where a CLT was made in the 7 years before a PET which has failed, that CLT will still be taken into account to calculate if tax is payable on the failed PET.