# 8. Inheritance tax and trusts

## 8.1 Introduction

Making gifts – whether outright or to a trust – has inheritance tax (IHT) consequences. The gift will either be exempt, potentially exempt or chargeable. The IHT treatment of a transfer of property to trustees depends on the type of trust being established.

Inheritance tax can also apply to property held in a discretionary trust, a post-21 March 2006 interest in possession trust or an accumulation and maintenance trust on every 10-year anniversary of the trust or when capital is distributed out of that trust, in accordance with what is known as the “relevant property regime”. This is dealt with in **Chapter 9**.

A discussion of the IHT treatment of absolute trusts follows immediately below. Other trusts are covered thereafter. See **8.5** for details of the special rules that apply to certain life assurance policies.

## 8.2 Absolute (bare) trusts

When a gift is made to an absolute (bare) trust, it is treated for IHT as a gift to the absolutely entitled beneficiary and so will be an exempt transfer if the beneficiary is the settlor’s spouse, and otherwise a potentially exempt transfer (PET). Therefore, there can be no liability unless the donor dies within seven years of making the gift, and even then a transfer of value will only apply to the extent that the transfer is not covered by exemptions – such as the £3,000 annual exemption.

**Example**

Geoff gifts £400,000 to an absolute trust on 1 February 2017. No inheritance tax arises because it is a PET. Geoff dies on 1 April 2020 when the IHT nil rate band is £325,000. The PET is now chargeable. Because Geoff did not otherwise use his annual exemptions of £3,000 in 2015-16 and 2016-17, the chargeable transfer can be reduced to £394,000 (i.e. £400,000 – £6,000). IHT will be £27,600 (i.e. £394,000-£325,000 @ 40%). This can be further reduced by 20% taper relief because Geoff survived his gift by between 3 and 4 years and so the IHT is reduced to £22,080 which is payable by the trustees of the absolute trust.

Once the gift has been made, the trust property will immediately become comprised in the estate of the absolutely entitled beneficiary for IHT purposes, and so will be potentially taxable upon his or her death. There will be no further IHT liability when capital payments are made from the bare trust to the beneficiary or beneficiaries entitled (i.e. upon them reaching 18). This is because for IHT purposes the trust property is already treated as belonging to the beneficiaries.

## 8.3 All other trusts

Apart from absolute/bare trusts, the only other trusts that benefit from PET treatment on lifetime gifts are trusts for the disabled. To qualify as a disabled trust, the trust must satisfy the conditions in IHTA 1984, s. 89, 89A or 89B (see **Chapter 37**). It may also still be possible to secure PET treatment on a gift to a pre-2006 flexible interest in possession trust where the trust holds a pre-2006 life insurance policy (see **8.5** below).

A different IHT treatment applies to lifetime gifts to all trusts other than absolute and disabled trusts. This will include lifetime gifts to:

- discretionary trusts;
- interest in possession (IIP) trusts; and
- accumulation and maintenance (A&M) trusts.

Transfers into these trusts are treated as chargeable lifetime transfers. This means that there could be an immediate IHT liability (again, subject to the usual exemptions and subject to the cumulative total of transfers exceeding the nil rate band) at a rate equal to one half of the death rate. This is increased to the full death rates – subject to taper relief – if the settlor dies within seven years.

Prior to 22 March 2006, gifts to IIP trusts and qualifying A&M trusts qualified for PET treatment. Lifetime gifts made:

- to such trusts created on or after 22 March 2006; or
- after 21 March 2006 to most flexible type trusts created before 22 March 2006

are now chargeable lifetime transfers.

An exception exists in relation to gifts to life policies effected subject to a trust prior to 22 March 2006 (see **8.5** below).

**Example**

Sally sets up an absolute trust for £100,000 on 1 December 2013. She then establishes a discretionary trust for £325,000 on 1 February 2014. She is using her annual exemptions elsewhere.

No IHT arises on the gift to the absolute trust. It is a PET. No IHT arises on the gift to the discretionary trust. Whilst it is a chargeable lifetime transfer, it does not cause her to exceed her nil rate band, the gift to the absolute trust as a PET being ignored.

Sally dies on 12 October 2020.

The IHT consequences are:

- The PET to the absolute trust becomes chargeable. No IHT arises because it falls within the nil rate band.
- IHT is recalculated on the gift to the discretionary trust. This is the top £325,000 of a cumulative total chargeable transfer of £425,000, the PET having become chargeable. On the basis that the nil rate band in 2020-21 was £325,000, the IHT charge will be £100,000 @ 40% = £40,000.
- This IHT liability can be reduced by taper relief of 80% (6 years' survival), so the IHT payable is £8,000.

In some cases, a cumulation period of 14 years can apply. Suppose, for example, that an individual:

- sets up a discretionary trust for £100,000 (net of exemptions) on 10 August 2005;
- creates a bare trust for £300,000 (net of exemptions) on 10 June 2012; and
- dies on 10 May 2019.

At first sight it might be thought that there would be no IHT on the failed PET because it would fall within the settlor's nil rate band. However, once the PET fails, it is necessary to go back seven years from the date of the PET, to establish whether any chargeable lifetime transfers were made in the preceding seven years. The £100,000 gift on 10 August 2005 would therefore cumulate with it, meaning that IHT on the failed PET would be:

| | £ | £ |
|---|---|---|
| Transfer | | 300,000 |
| NRB | 325,000 | |
| Less cumulative transfers in seven years | (100,000) | (225,000) |
| Taxable element of gift | | 75,000 |
| Tax @ 40% | | 30,000 |
| Taper @ 80% * | | (24,000) |
| Tax payable | | 6,000 |

* death occurs six to seven years after making the gift.

**Note**: The 14-year rule is not relevant for the purposes of calculating the remaining NRB available to offset against the death estate. This would therefore be £25,000 (£325,000-£300,000).

**Law:** IHTA 1984, s. 89, 89A, 89B

## 8.4 Inheritance tax after the trust has been created

Generally speaking, the IHT position after the trust has been created will be either that the trust will be subject to the 10-yearly and interim exit charges specific to the relevant property regime; or the trust fund will be taxed on the death of a person with a qualifying interest in possession as part of his estate. Whether or not an interest in possession is a qualifying one, will depend largely on when the trust was created.

### *8.4.1 Pre-22 March 2006 interest in possession trusts*

Most interest in possession trusts created after 21 March 2006 during the settlor's lifetime are now taxed in the same way as discretionary trusts for IHT purposes and so are subject to the "relevant property regime" (see **Chapter 9**).

However, where a beneficiary has an interest in possession in a pre-22 March 2006 trust he will be treated, for IHT purposes, as if he owned the trust property supporting that interest. The IHT position will depend on whether that interest terminates during lifetime or on death.

#### *On death*

The trust capital will be deemed to form part of the beneficiary's estate for the purposes of calculating IHT and should benefit from a share of the beneficiary's nil rate band (and possibly residence nil rate band) upon his death. If the trust interest passes to the deceased beneficiary's spouse under the trust, then the spouse exemption will apply.

As far as the ongoing taxation of the trust is concerned, if the interest in possession passes to the deceased beneficiary's spouse on the death of the beneficiary with the interest in possession, it will continue to be taxed as an interest in possession trust and not be subject to the IHT relevant property rules that apply to discretionary and post-21 March 2006 interest in possession trusts. If the interest passes to anybody other than the deceased beneficiary's spouse, it will then fall within the relevant property provisions for IHT purposes (see **Chapter 9**). As an exception to this rule, where the trust property is a life assurance policy owned by the trust before 22 March 2006, the trust will continue to be taxed as an interest in possession trust regardless of the identity of the new beneficiary, provided that the new interest takes effect on death.

### *During lifetime*

If, on the cessation of the beneficiary's interest in possession during lifetime, another individual becomes absolutely entitled this will be treated as giving rise to a PET of the capital value supporting the interest.

No charge to IHT will arise if the property reverts to the settlor at that time. Further, no charge will arise if the property reverts to the settlor's spouse, settlor's widow or widower within two years of the settlor's death or if the beneficiary entitled to the interest in possession has that interest enlarged to an interest in the trust capital.

If another individual becomes entitled to a life interest (or the interest goes onto discretionary trusts), this will be treated as a chargeable lifetime transfer by the beneficiary losing his interest in possession and the trust capital in which the income entitlement subsists will then be treated as being held on relevant property trusts for IHT purposes (see **Chapter 9**). The trust will still retain the original creation date for the purposes of determining the dates of future periodic (and exit) charges.

On any chargeable transfers arising during lifetime, the beneficiary's £3,000 annual exemption(s) may be available for offset.

## *8.4.2 Post-21 March 2006 interest in possession trusts*

Most interest in possession trusts that come into existence post-21 March 2006 will now be taxed in the same way as discretionary trusts (i.e. under the relevant property regime). However, certain special categories of interest in possession trusts continue to benefit from pre-22 March 2006 treatment. These include immediate post-death interests, trusts for the disabled and transitional serial interests.

### *Immediate post-death interest (IPDI) trusts*

As discussed above, most interest in possession trusts (including "flexible" power of appointment trusts) established after 21 March 2006 are taxed in the same way as discretionary trusts for IHT purposes (i.e. under the relevant property regime – see **Chapter 9**).

However, an important exception exists in relation to immediate post-death interest (IPDI) trusts. To qualify as an IPDI trust, property must pass into the trust on the death of an individual – either via his will or on an intestacy. If this condition is satisfied and the property is then held on a trust where an individual has an immediate interest in possession, it will be taxed in a similar way to a pre-22 March 2006 trust. This means that the IIP beneficiary will be treated for IHT purposes as owning the capital that supports the income interest. However, on the cessation of the IPDI interest, if the trust continues it will then be taxed in accordance with the relevant property regime.