Periodic and Exit charges

Briefing Note

Any non-exempt gifts into a trust that are subject to the relevant property regime are treated as chargeable lifetime transfers and carry with them the possibility of a number of inheritance tax charges. The relevant property regime applies to trusts such as discretionary trusts and lifetime interest in possession trusts.

At outset, if the gift (together with any other chargeable lifetime transfers in the last seven years) exceeds the available nil rate band then there is a 20% lifetime inheritance tax charge on the excess. Many advisers and clients will therefore ensure that the amount of the chargeable lifetime transfer is within their available nil rate band, meaning that the gift is taxable at 0%.

During the life of the trust, there will be calculations needed on every ten-year anniversary and when any assets are distributed by the trustees to the beneficiaries.

Periodic charges

It is the trustees responsibility to calculate, report and pay any periodic charge for the trust. On every ten-year anniversary, the trustees will need to compare the value of the trust fund with the level of nil rate band in force at that time.

If the value of the trust fund is greater than the available nil rate band on the ten-year anniversary a periodic charge will apply. The available nil rate band used is the nil rate band on the ten-year anniversary, reduced by any other chargeable lifetime transfers made by the settlor in the seven years before commencement of the trust and any distributions of capital to the beneficiaries in the previous ten years.

- Establish the available nil rate band. This will be the nil rate band at the tenth anniversary less any chargeable lifetime transfers made by the settlor in the seven years prior to this trust being created and any distributions from the trust to the beneficiaries in the previous ten years. Remember that the available nil rate band can never reduce below zero.
- Obtain the value of the trust on the tenth anniversary.
- If the value of the trust fund exceeds the available nil rate band, the excess is taxed at 6%.

Therefore where there have been no distributions of capital to the beneficiaries and no previous chargeable lifetime transfers by the settlor, the calculation will look like this:

- **Value of trust - nil rate band = notional transfer**
- **notional transfer x 20% = IHT on notional transfer**
- **IHT on notional transfer / value of trust fund x 100 = effective rate of tax**
- **effective rate of tax x 30% = actual rate of tax**
- **Value of trust fund x actual rate of tax = periodic charge**

It is important to remember that if the settlor made any other chargeable lifetime transfers at any time in the seven year period before creating the trust, or the trustees have made a distribution to the beneficiaries the full nil rate band will not be available and the chances of a periodic charge will be that much greater.

Exit charges

When money is distributed to beneficiaries, an inheritance tax exit charge could apply.

- **Exit charges in the first ten years**
  If lifetime inheritance tax was payable at outset, exit charges will apply in the first ten years. If there was no lifetime inheritance tax payable at outset, there will be no inheritance tax exit charges on any distributions of capital to the beneficiaries in the first ten years.
  The position can change on death if a failed potentially exempt transfer causes a subsequent chargeable lifetime transfer to exceed the available nil rate band.

  Where a discretionary trust has been set up on death through a will then exit charges can apply, even if there is no entry inheritance tax charge. This could occur, for example, where the deceased's estate is entitled to a transferable nil rate band from a previously deceased spouse and the amount settled into trust on death exceeds a single nil rate band. A trust with a single settlor is only entitled to a single nil rate band when considering exit and periodic charges.

  Any exit charge due in the first ten years of a trust is based on the value of the assets settled into the trust when they were gifted.
- **Exit charges after the first ten years**
  Once the trust has passed its first ten-year anniversary, inheritance tax exit charges are always based on the effective rate of tax used for the previous ten-year anniversary charge. If this was zero, there will be no inheritance tax exit charges on any distributions of capital to the beneficiaries in the following ten years.

For the calculation, you must establish the effective rate of tax applying to the trust at outset or at the ten-year anniversary.

This tax rate is then applied to the amount of the capital distribution. However, there is a proportionate reduction based on the number of complete calendar quarters since the last ten-year anniversary, or since outset if within the first ten years.

The calculation is therefore:
Exit charge = amount of capital distribution x (tax suffered by trust / value of the trust at inception or the 10th anniversary) x X/40

The 'X factor' represents the number of complete calendar quarters, with 40 representing the number of quarters in a ten-year period.

Here are a few examples of how the charges would be applied.

Scenario 1

Discretionary gift trust

- In May 2010, a client gifts £206,000 into a discretionary gift trust.
- £6,000 is covered by 2 x annual gift allowances, therefore chargeable lifetime transfer is £200,000.
- Nil rate band at the time was £325,000 and there were no other chargeable lifetime transfers by the same client in the preceding seven years. Therefore, no lifetime inheritance tax charge at outset.
- There are no capital distributions to the beneficiaries in the first ten years.
- On the ten-year anniversary in May 2020, the trust is valued at £400,000.

Periodic charge

- notional transfer = £400,000 - £325,000 = £75,000
- IHT on notional transfer = £75,000 x 20% = £15,000
- effective rate of tax = £15,000/£400,000 x 100% = 3.75%
- actual rate of tax = 3.75% x 30% = 1.125%
- periodic charge = £400,000 x1.125% = £4,500 payable by the trustees.

Exit charge

- Two years later in 2022, the trust is valued at £500,000 and the trustees distribute the money to the beneficiaries.
- The actual rate of tax for the trust is £4,500 / £400,000 = 1.125%.
- The trust has completed eight quarters of the ten-year period, therefore the tax is reduced proportionately by 8/40.
- The exit charge = £500,000 x 1.125% x 8/40 = £1,125

Periodic and Exit charges

Scenario 2

Discretionary gift trust

- In May 2010, a client gifts £206,000 into a discretionary gift trust (Trust A).
- £6,000 is covered by 2 x annual gift allowances, therefore chargeable lifetime transfer is £200,000.
- The inheritance tax charges for Trust A are as Scenario 1.
- In May 2016, the same client gifts £131,000 into another discretionary gift trust (Trust B).
- £6,000 is covered by 2 x annual gift allowances, therefore chargeable lifetime transfer is £125,000.
- Nil rate band at the time was £325,000.
- There was a chargeable lifetime transfer by the same client in the preceding seven years, but there is no lifetime inheritance tax charge at outset because the total (£200,000 + £125,000) does not exceed the nil rate band.
- There are no capital distributions to the beneficiaries of Trust B in the first ten years.
- On the ten-year anniversary in 2026, Trust B is valued at £250,000 and the nil rate band is, say, £375,000.

Periodic charge

- The available nil rate band is £175,000 (£375,000 minus £200,000 (chargeable lifetime transfer for Trust A)).
- notional transfer = £250,000 - £175,000 = £75,000
- IHT on notional transfer = £75,000 x 20% = £15,000
- effective rate of tax = £15,000/£250,000 x 100% = 6%
- actual rate of tax = 6% x 30% = 1.8%
- periodic charge = £250,000 x1.8% = £4,500 payable by the trustees.

Exit charge

- Two years later in 2028, Trust B is valued at £300,000 and the trustees distribute the money to the beneficiaries.
- The actual rate of tax for the trust is £4,500 / £250,000 = 1.8%.
- Trust B has completed eight quarters of the ten year period, therefore the tax is reduced proportionately by 8/40.
- The exit charge on Trust B = £300,000 x 1.8% x 8/40 = £1,080

Scenario 3

Discretionary will trust

- In May 2016, a widow settles £106,000 into a discretionary trust.
- £6,000 is covered by 2 x annual gift allowances. Although the remainder is a chargeable lifetime transfer, it is within her nil rate band so no entry inheritance tax charge arises.
- She dies in May 2020 and settles £300,000 into a discretionary will trust.
- Her executors are able to use her nil rate band and, since her husband did not use any of his nil rate band, the widow's nil rate band can be enhanced by 100%. That means that, although the chargeable lifetime transfer plus the discretionary will trust exceeds a single nil rate band, the total is within the enhanced nil rate band of £650,000, therefore no entry inheritance tax charge arises.

Exit charge

- After two years in 2022, the trustees of the will trust distribute £100,000 to the beneficiaries.
- Although there was no entry charge, a trust with a single settlor only has one nil rate band for the purposes of periodic and exit charge calculations, so it is necessary to work out the effective rate of tax applicable to the trust.
- This is £300,000 – (£325,000 - £100,000) = £75,000 x 6% = £4,500
- The effective rate of tax for the trust is £4,500 / £300,000 = 1.5%
- The trust has completed eight quarters of the ten year period, therefore the tax is reduced proportionately by 8/40.
- The exit charge is £100,000 x 1.5% x 8/40 = £300.

This document is based on Canada Life's understanding of applicable UK tax legislation and current HM Revenue & Custom's practice, as at October 2020 and could be subject to change in the future. It is provided for professional advisers only. Any recommendations are the adviser's sole responsibility.

ican Technical Services

canadalife.co.uk/ican

canada life

ID6769 – 1020R/B