

DISCRETIONARY TRUSTS

CREATED BY UK DOMICILED INDIVIDUALS

WHAT DO YOU NEED TO KNOW ABOUT PERIODIC AND EXIT CHARGES?

PERIODIC CHARGES

At every tenth anniversary, a discretionary trust will need to be reviewed to establish whether or not the trustees have any reporting requirements to HMRC.

Unless the trust is treated as an Excepted Settlement under UK tax law (broadly where the total notional chargeable transfer value on the ten year anniversary does not exceed 80% of the Inheritance Tax (IHT) nil rate band (NRB)) there is a requirement for trustees to report to HMRC within 6 months of the anniversary date. The following 3 points should be considered in determining the total notional chargeable transfer value on the ten year date:

1 The surrender value of the trust fund at the tenth anniversary

For a discretionary **loan trust**, this is the surrender value of the RL360 product at the ten year anniversary.

However, there will only be a tax charge if the value minus any outstanding loan balance, exceeds the IHT NRB (currently £325,000).

For a discretionary **gift trust**, this is the surrender value of the RL360 product at the ten year anniversary.

Where there is a discretionary **discounted gift trust**, the value to be used will be the surrender value of the bond at the ten year anniversary, minus the recalculated discount for inheritance tax based upon current age, plus any medical rating applied at outset.

PLUS

2 The value of any payments made to any discretionary beneficiary in the previous ten years

Loan repayments under a discretionary loan trust or income payments to the settlor on a discretionary discounted gift trust are ignored.

PLUS

3 The value of any other chargeable lifetime transfers (CLTs) made by the client in the seven years prior to the start date of the discretionary trust.

Where there have been no distributions to the beneficiaries in the last ten years, no previous CLTs by the settlor in the 7 years prior to the trust creation date, the NRB should be fully available to be offset in the periodic charge computation.

The periodic charge computation can be complex, but where the NRB is fully available to the trustees, it is deducted from the value of the trust. Then, the lifetime rate of 20% is applied to the value over the NRB to work out the effective rate. This is then reduced further to work out the actual settlement rate which is 30% of the effective rate.

The prescribed steps must be followed to arrive at a settlement rate which is then applied to the value of the trust at the ten year anniversary. The maximum settlement rate of tax which can apply to the value of the trust fund at each ten year anniversary is 6% (20% x 30%), but it is often less depending on the availability of the NRB.

(Please see example 2 - Periodic charge for a basic example).

EXIT CHARGES

When distributions are made to the beneficiaries, an IHT exit charge could apply.

Exit charges in the first 10 years

- Only if IHT was payable at outset (i.e. the NRB was exceeded over a 7 year period) will an exit fee apply in the first 10 years.
- Therefore, if no IHT was payable at outset, then no IHT charge will apply to a distribution in the first 10 years.

Exit charges after the first 10 years

- After the first 10 year anniversary, exit charges are based upon the settlement rate of tax charge at the previous ten year anniversary.
- If there was no periodic charge at the last 10 year anniversary, then there will be no IHT exit fee in the next 10 years.

In order to calculate the exit charge, the settlement rate of tax needs to be established that applies to the trust at outset (if within the first 10 years) or at the last ten year anniversary, (if after the first 10 years).

This rate is then applied to the amount of the distribution and is then proportionately reduced for the number of complete quarters since either outset or the last 10 year anniversary, whichever is relevant.

EXAMPLE 1 - DISCRETIONARY GIFT TRUST

- On the 1st September 2011, a client gifts £106,000 into a discretionary gift trust.
- The first £6,000 was exempt as this used the annual exemption allowance for that tax year and the previous tax year, leaving a CLT of £100,000.
- The NRB was £325,000 at this time and the client made no other transfers in the previous 7 years, therefore no lifetime IHT charge applied at outset.
- On the ten year anniversary, the trust is valued at £163,000 (assuming an annual 5% growth rate net of all charges).

Periodic charge

- As the value is below £325,000, **no periodic charge will apply.**

Two years later, the trust then is wound up and the monies fully distributed to the beneficiaries.

Exit charge

- As there was no periodic charge at the last ten year anniversary, no exit charge will apply to the distributions to the beneficiaries.

The exit charge calculation is:

Value of distribution to beneficiary x settlement rate of tax at outset or previous 10 year anniversary x $X^*/40$.

* X is the number of complete calendar quarters since the last 10 year anniversary, with 40 being the total number of quarters in a 10 year period.

IMPORTANT NOTES

For financial advisers only. Not to be distributed to, nor relied on, by retail clients.

Every care has been taken to ensure that the information provided is current and in accordance with our understanding of current law and Her Majesty's Revenue and Customs' (HMRC) practice as at June 2022. You should note that we cannot take on the role of an individual taxation adviser and independent confirmation should be obtained before acting or refraining from acting upon the information given. The law and HMRC practice are subject to change.

EXAMPLE 2 - DISCRETIONARY GIFT TRUST

- On the 1st September 2011, a client gifts £216,000 into a discretionary gift trust.
- The first £6,000 was exempt as this used the annual exemption allowance for that tax year and the previous tax year, leaving a CLT of £210,000.
- The NRB was £325,000 at this time and the client made no other transfers in the previous 7 years, therefore no lifetime IHT charge applied at outset.
- On the ten year anniversary, the trust is valued at £342,000 (assuming an annual 5% growth rate net of all charges).

Periodic charge

- The settlement rate should be
 $£342,000 - £325,000 = £17,000$
 $£17,000 \times 30\% \times 20\% = £1,020$

This is a settlement rate of 0.300% (rounded up; $£1,020 \div £342,000$)

The periodic charge is therefore:
 $£342,000 \times 0.300\% = \textbf{£1,026}$

Two years later, the trust then is wound up with a value of £377,000 and the monies are fully distributed to the beneficiaries.

Exit charge

- The exit charge = $£377,000 \times 0.300\% \times 8^*/40 = \textbf{£226.20}$

* 8 is the number of complete calendar quarters since the last 10 year anniversary, with 40 being the total number of quarters in a 10 year period.