CHAPTER 7

INHERITANCE TAX – PRINCIPAL CHARGES

7.1 The principal charge

A principal charge will be levied on **each 10-year anniversary** following the commencement of the trust. The rules for calculating principal charges changed with effect from March 1974, and in this manual we shall confine our discussions to post 1974 trusts only.

The principal charge is a **percentage of the value of the trust** at the 10 year anniversary, ie

Value of relevant property @ 10-year anniversary x actual rate of tax

As was the case for exit charges, we shall use a procedure to determine the actual rate of tax.

The trustees are deemed to have made a transfer of value equal to the value of the trust at the 10-year date. Because this is a chargeable transfer, the value of relevant property at the date of the principal charge can be **reduced by any APR or BPR.** This means that if the assets of the trust consist wholly of shares in an unquoted trading company qualifying for 100% business property relief, the principal charge will be zero.

As is the case for exit charges, the **actual rate** of tax is arrived at by determining the **effective** rate of tax, and **multiplying this by 30%.**

For exit charges, we then multiply this rate by n/40 when "n" is the number of quarters that have elapsed between the date of creation and the date of the exit charge. When looking at principal charges, the number of quarters between the date of commencement and the first principal charge will be exactly 40. As this **fraction gives a figure of one,** it can be ignored.

7.2   The effective rate

The first thing we must therefore do to calculate the principal charge, is to arrive at the effective rate.

The effective rate is a **notional rate** of IHT which would be charged on a **notional transfer**. To calculate the effective rate, we use the IHT history of the **settlor** of the trust. To calculate the effective rate, we pretend that the settlor had made a **transfer of value equal to the relevant property** in the trust **at the 10 year anniversary**.   This notional transfer is increased by adding on the **initial value of a related trust**. Remember that a related trust was a trust set up on the same day by the same settlor.

To calculate the **notional tax**, we use the IHT **nil band at the date of the 10 year charge**. Therefore for 10 year charges falling into 2010/11, the nil band we use is £325,000. This nil band is reduced by the **settlor's cumulative chargeable transfers**. Here we look back at the settlor's **transfers in the 7 years prior to the creation of the trust**. Note we do **not** simply look at transfers made in the 7 years prior to the 10 year charge.

The nil band is further reduced by any **distributions** made by the trustees in the **10 years preceding** the principal charge. Therefore any exits made in the first 10 years of the trust will affect the first principal charge. Once we have the nil band remaining, we can calculate the notional tax and thereafter calculate the effective rate.

Principal charge proforma;

	£	£
Current value of relevant property at 10 year anniversary (net of APR/BPR)		A
Initial value of related trust		$\underline{B}$
		C
Nil band at date of principal charge	NB	
Less: settlor's chargeable transfers in 7 years before creation of trust	(CTs)	
Less: distributions by trustees in last 10 years	$\underline{(D)}$	
Nil band remaining		$\underline{(NBR)}$
		$\underline{E}$
Notional tax at 20%		$\underline{NT}$

$$\text{Effective rate} = \frac{NT}{C} \times 100 \qquad\qquad \underline{ER\ (\%)}$$

Actual rate = ER% x 30% $\underline{AR\ (\%)}$

Principal charge = Current value x AR (%) = $\underline{PC}$

Illustration 1

On 7 August 2000, Frederick created a discretionary trust with £600,000 in cash. Frederick paid the IHT on the creation of the trust. His chargeable transfers in the 7 years prior to setting up the trust were £120,000.

On 15 December 2004, the trustees distributed £85,000 to a beneficiary. This gave rise to an IHT exit charge. The beneficiary paid the tax on the exit.

On 7 August 2010 – i.e. 10 years after the commencement of the trust – the relevant property within the trust was worth £900,000. Our requirement is to calculate the principal charge arising in August 2010.

	£	£
Current value of relevant property		900,000
Initial value of related trust		<u>Nil</u>
		900,000
Nil band at August 2010	325,000	
Less:		
CTs in 7 years pre creation of trust	(120,000)	
Distributions in last 10 years	<u>(85,000)</u>	
Nil band remaining		<u>(120,000)</u>
Chargeable		<u>780,000</u>
Notional tax at 20%		<u>£156,000</u>

$$\text{Effective rate} = \frac{156000}{900000} \times 100 \qquad \underline{17.333\%}$$

Having calculated an effective rate, we will turn this into an actual rate and thereafter calculate the principal charge.

$$\text{Actual rate} = 17.333\% \times 30\% \times \frac{40}{40} = \underline{5.2\%}$$

$$\text{Principal charge} = 5.2\% \times £900,000 = \underline{£46,800}$$

In no circumstances can the actual rate ever exceed 6%. This tax is payable by the trustees on 30 April 2011. The normal due date for payment of tax under s.226 IHTA 1984, is the later of 6 months from the end of the month of the transfer, or 30 April in the following tax year.

Even though this tax is payable by the trustees, no grossing up is necessary as the only asset leaving the trust is the cash being used to pay the IHT.

As you will see from the above illustration, the calculation of tax on a principal charge is very similar to the calculation of tax on an exit charge. In both instances we calculate an effective rate, and multiply this by 30% to get an actual rate. We then use that actual rate to calculate the IHT. However, when calculating tax on principal charge, the "n/40" fraction is not a problem as 40 complete quarters will have elapsed.

7.3   Miscellaneous points

The **current value** of relevant property at the 10-year date is **net of any APR or BPR**. APR or BPR will be given provided that the trustees have relevant business or agricultural property, and have satisfied **minimum ownership requirements**. Therefore a principal charge cannot be avoided by the trustees simply swapping assets for relevant business property immediately prior to the 10-year charge as the 2 year ownership period would not have been satisfied.

IHTA 1984, s.106
IHTA 1984, s.117

Any exit charges made by the trustees in the 10 years preceding the principal charge, will affect the actual rate of tax. The amount of property leaving the trust is not necessarily the same as the value of the property being transferred to the beneficiaries. We use the "loss to trust" principle to calculate the reduction in the value of relevant property. In addition, **if IHT on the exit was paid by the trustees, this tax must be added to the distribution** to find the "loss to trust". For example, if trustees distributed £100,000 to a beneficiary and the trustees paid tax of £5,000 on the exit, the "loss to trust" in the previous 10 years would have been £105,000.

IHTA 1984, s.66(5)(b)

Finally, the notional transfer at the 10-year date is the current value of relevant property plus the **initial value** of property in a related trust. In your examination purposes, the examiner may give you a **current** value of a related trust. This is a red herring and will not affect the IHT calculations.

IHTA 1984, s.66(4)(c)

7.4   Exit charge after a principal charge

IHTA 1984, s.69

So far we have looked at how we calculate tax on an exit within the first 10 years of the trust, and how we work out the principal charge at the 10-year anniversary. The final thing we need to do is to look at how we calculate tax on **exits from the trust after the first principal charge**.

Where an exit take place after the first principal charge – ie property is distributed by the trustees more than 10 years after creation - we **do not use the original exit charge procedure to calculate the tax**. The exit charge procedure used in the previous chapter is only relevant for exits in the first 10 years.

To calculate tax on an exit after the first or later principal charges, we again calculate an effective rate, then turn that into an actual rate, and then use that actual rate to calculate the IHT. However, in this instance, **the effective rate we use is that which is in force at the date of the preceding principal charge**. This effective rate must be **adjusted if the IHT nil band has changed** between the date of the principal charge and the date of the exit.

IHTA 1984, s.69(1)

Having arrived at the effective rate, we then multiply that by 30% to arrive at the actual rate. As this is an exit charge, the rate must then be multiplied by n/40 where **"n" is the number of quarters between the date of the principal charge and the date of the exit**.

$$\text{Actual Rate} = \text{Effective Rate} \times 30\% \times \frac{n}{40}$$

This actual rate is then multiplied by the property leaving the trust to find the exit charge.

Illustration 2

Returning to the example of Frederick. Frederick set up a discretionary trust in August 2000. A distribution was made by the trustees in December 2004. In the previous example, we calculated the inheritance tax payable by the trustees on the principal charge on 7 August 2010.

On 21 December 2011, the trustees made a distribution of £120,000 to a beneficiary such that an exit charge will arise. Our requirement is to calculate the IHT on this exit.

The distribution takes place in the tax year 2011/12. The nil band for 2011/12 will be £325,000.

	£	£
Recalculate effective rate:		
Value at 7.8.10		900,000
Nil band at exit 2011/12	325,000	
Less b/fwd total	(120,000)	
Less exit 15.12.04	(85,000)	
Nil band remaining		(120,000)
		780,000
Notional tax at 20%		£156,000

$$\text{Effective rate} = \frac{156000}{900000} \times 100 \qquad \underline{17.333\%}$$

Actual rate = 17.333% x 30% x 5/40   <u>0.65%</u>

Exit charge = £120,000 x 0.65%   <u>£780</u>

Tax on the exit will either be paid by the trustees or the beneficiary. Remember that if the trustees pay the tax, this rate must be grossed up.

Assuming the tax is paid by the beneficiary, we can simply use the actual rate.

The exit charge is therefore the property leaving the trust multiplied by the actual rate, giving us an IHT charge of £780. This tax is payable by the beneficiary no later than 30 June 2012.

7.5   Future principal charges

Principal charges will be levied on **each 10-year anniversary** following the creation of the trust. Therefore for principal charges in year 20, 30, 40, etc we would use the normal principal charge procedure. For a principal charge at the 20 year anniversary point, we take the value of relevant property in the trust at the 20 year anniversary. To this we will add the initial value of any related trusts. The initial value is the value at the date that the related trust was created, not the value of the trust at the date of the principal charge.

To calculate the effective rate, we use a nil band at the date of the subsequent principal charge. This nil band is reduced by any chargeable transfers made by the settlor in the **7 years prior to the <u>creation</u>** of the trust and by any **distributions by the trustees in years 11 to 20.**

Therefore if we are calculating a principal charge in, say, 2013 on a trust set up in 1993, we would also need details of the settlor's chargeable transfers in the 7 years before 1993. Having calculated the chargeable amount, we work out notional tax and compute an effective rate. The effective rate is multiplied by 30% to give an actual rate. The actual rate is then multiplied by the current value of relevant property in the trust to arrive at the principal charge.

Example 1

Gabriel set up a discretionary trust on 10 April 2001 with £975,000 in cash. IHT of £145,400 was paid by the trustees. Gabriel had made no previous transfers.

On 1 January 2009, the trustees made a distribution of £200,000 to a beneficiary. IHT of £5,777 was paid by the trustees.

The trust assets were worth £1 million on 10 April 2011.

Calculate the principal charge

Example 2

Roberta created a discretionary trust on 21 March 1997. She had made no previous transfers. The trust assets were valued at £900,000 in March 2007. No capital distributions had been made.

On 15 September 2010, the trustees appointed £250,000 to a beneficiary. The trustees agreed to pay any IHT due.

Calculate the IHT payable on the distribution.

Answer 1

	£	£
Value at April 2011		1,000,000
Nil band 2011/12	325,000	
Less: settlor's b/fwd CTs	(Nil)	
Less: exits in last 10 years		
£(200,000 + 5,777)	(205,777)	
Nil band remaining		(119,223)
Chargeable		880,777
Notional IHT at 20%		£176,155

Effective rate = $\dfrac{176155}{1000000} \times 100$ 17.6155%

Actual rate = 17.6155% x 30%   5.285%

Principal charge: £1,000,000 x 5.285%   **£52,850**

Answer 2

	£	£
Value at March 2007		900,000
Nil band at 15.9.10	325,000	
Less: settlor's b/fwd	-	
Less: distributions	-	
Nil band remaining		(325,000)
Chargeable		575,000
Notional IHT at 20%		£115,000

Effective rate = $\dfrac{115000}{900000} \times 100$ 12.778%

Actual rate = 12.778% x 30% x $\dfrac{13}{40}$ 1.246%

Gross up rate: $\dfrac{1.246}{100-1.246}$ 1.262%

Exit charge: £250,000 x 1.262%   **£3,155**