Additional problems

Meg Saksida explains how to deal with additions in calculating exit charges in the first ten years in relevant property trusts.

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Relevant property trust calculations can be tricky. Entry charges, exit charges and periodic charges are all required to be calculated, but none are more complicated than the additions calculations. In accounting for additions to a settlement, whether calculating either the exit charge or the periodic charge, any additions up to the exit (or during the period leading to the ten-yearly charge) need to be considered separately to the original trust property. This is because the added property has not been in the settlement for the entire time the tax charge is being charged over.

The method employed for dealing with additions can sometimes be difficult to understand because, although the trust property has clearly not been inside the settlement for the whole period, it is included *in its entirety* in calculating the value of the trust for calculating the percentage which is to be later used for taxing the trust property at the date of the exit or the ten-yearly charge. This percentage will later be pro-rated for the appropriate time period when the actual percentage to be applied to the trust property is calculated; but initially, the total amount of the addition is included.

As a reminder the pro forma for an exit charge in the first ten years is as follows:

	£	£
Value of trust relevant property at the inception of the trust		X
Value of trust relevant property in a related trust at the inception of the trust		X
Combined value of the trust		X
Nil rate band at the date of the exit	X	
Settlors chargeable transfers in the seven years before the inception of the trust	(X)	
		(X)
Value of the trust for calculating the percentage		X

Key points

- Additions must be included in their entirety when calculating the value of the trust for exit or ten-yearly charge percentage.
- The actual percentage is the legislative percentage for *existing* property.
- There are two ways of making the calculation.

We then need to establish a percentage based on the value of the trust at the inception for calculating the percentage above. In order to do this, a standard set of five steps needs to be taken. These are:

1) The notional tax. This is the value of trust for calculating the percentage taxed at 20% (the lifetime rate of inheritance tax).
2) The effective percentage. This is the above notional tax amount calculated at step 1 divided by the combined value of the trust.
3) The legislative percentage. IHTA 1984, s 68 states that the effective percentage can be multiplied by 'three tenths', so 30%. The legislative percentage is applied to the effective percentage calculated at step 2 x 30%.
4) The actual percentage. The actual percentage is the legislative percentage calculated at step 3 x n/40 for existing property; 'n' is the number of quarters from the inception of the trust to the date of the exit, in other words the total time that the trust property has been in the trust for before the exit.
5) Finally, the exit charge is the loss to the trust multiplied by the actual percentage calculated at step 4. This gives the inheritance tax charge payable and needs to be grossed up if paid by the trustees.

When additions are made to a relevant property trust, the first important change to the above is that the amount of the addition is included in total in the calculation in the value of the trust for calculating the percentage. It does not matter if the trust property exiting was from the added property or not, or how long the added property was in the trust for.

All these complications are dealt with in the fine tuning of the percentage, but when calculating the value of the trust for calculating this percentage, the additions are included in full.

The following is the pro forma for an exit charge in the first ten years where there has been an addition:

	£	£
Value of trust relevant property at the inception of the trust		X
Value of trust relevant property in a related trust at the inception of the trust		X
Value of the trust relevant property added to the trust in the period before the exit		X
Combined value of the trust		X
Nil rate band at the date of the exit	X	
Settlors chargeable transfers in the seven years before the inception of the trust	(X)	
	(X)	
Value of the trust for calculating the percentage		X

Most of the subsequent steps (steps 1 to 4) are the same. However, it is step 4, the actual percentage, which changes where there has been an addition.

The actual percentage is the legislative percentage calculated at step 3 x n/40 for existing property. However, when additions have been added to the settlement, n/40 is not enough if the distribution has come out of the added property. This is because 'n' represents the number of quarters from the inception of the trust to the exit, and this will be greater than the time that the added trust property has been in the trust for. Because the added property has not been in the trust for the whole period up to the exit, rather than n/40, we therefore need to isolate the period that the added trust property was inside the trust for.

There are two ways of doing this. The first is to count the actual quarters the trust property was in the trust for before the exit. However, beware, as this is not the method legislated. The provisions in IHTA 1984 state that rather than counting the period the added trust property was in the trust, we need to deduct from n, the period that the added trust property was not in the trust. This will leave us with the number of quarters that the added trust property was in the trust. Most of the time this will be the same as counting the quarters the property was in the trust for, but sometimes this will be a quarter different so it is important that the correct method is chosen.

For example, a trust is set up on 12 June 2015, with an addition on 1 December 2018 and an exit on 30 June 2020. Isolating how many months the added property was in the trust for would be calculated as 1 December 2018 to 30 June 2020. This is six quarters. However, the method we must use instead, is to take the quarters from the inception to the exit, 12 June 2015 to 30 June 2020, 20 quarters, and then subtract the quarters from the inception of the trust and the addition (where the added trust property was not in the trust) which is from 12 June 2015 to 1 December 2018, 13 quarters. This totals seven quarters not six, giving a different 'n' and therefore a different percentage. Care must therefore be taken to use the correct calculations in order to get to correct figure.

Once the period of time the added property has been in the trust has been calculated (in our above example 13 quarters) this is divided by 40 quarters to obtain the percentage the added property has been deemed to be trust for, and this actual percentage is applied to the legislative percentage (calculated in step 3) to uncover the actual percentage to be used to tax the capital exited.

"The actual percentage is the legislative percentage calculated at step 3 x n/40 for existing property."

Illustrations

The following examples show what happens:

- when the exit was made out of added property;
- when the exit was made out of the original trust property; and
- when the exit was made from a combination of original and added trust property.

Added property

Jonty, who had not made any previous transfers settled property into a discretionary trust on 13 January 2013 with £700,000 of quoted shares for his four grandchildren. Jonty paid the entry charge. On 7 July 2017 Jonty added £200,000 cash to the trust. In June 2021 one of the grandson's had lost his job because of the pandemic and the trustees used their discretion to pay £100,000 of the capital to him on 17 June 2021 in cash. The grandson paid any exit charge due.

What was the exit charge on the trustee's £100,000 capital payment to Jonty's grandson?

	£	£
Value of trust relevant property at the inception of the trust		700,000
Value of trust relevant property in a related trust at the inception of the trust		0
Value of the trust relevant property added to the trust in the period before the exit		200,000
Combined value of the trust		900,000
Nil rate band at the date of the exit	325,000	
Settlors chargeable transfers in the seven years before the inception of the trust	(0)	
		(325,000)
Value of the trust for calculating the percentage	575,000	

1) The notional tax. This is the value of trust for calculating the percentage, £575,000 taxed at 20%, the lifetime rate of inheritance tax = £115,000.

2) The effective percentage. This is the above notional tax amount calculated at step 1, £115,000 divided by the taxable combined value of the trust £900,000 = 12.777%.
3) The legislative percentage. The legislative percentage is applied to the effective percentage calculated at step 2, so 12,77% x 30% = 3.833%.
4) The actual percentage. The actual percentage is the legislative percentage calculated at step 3 x (n-x)/40 for added property where 'n' is the number of quarters from the inception of the trust to the date of the exit, and x is the number of quarters from inception to the date of the addition.

Formula letter	Date period	Quarters
n	13 January 2013 to 17 June 2021	33
x	13 January 2013 to 7 July 2017	17

3.833 x (33-17)/40
3.833 x 16/40= 1.533%

5) Finally, the exit charge is the loss to the trust multiplied by the actual percentage calculated at step 4 – 1.533% multiplied by the exit of £100,000 = £1,533.

Original trust property

If the trustees of Jonty's discretionary trust made the £100,000 payment of the capital out to the grandson in quoted shares, there would be a small change to the calculation, but this would not be evident until step 4 of the percentage calculation.

Whether the capital paid out was from cash (added property) or shares (original property), the whole amount of the added property is added in arriving at the value of the trust for calculating the percentage. This is therefore unchanged from the previous example at £575,000.

> "The whole amount of the added property is added in arriving at the value of the trust for calculating the percentage."

In addition, the notional tax, the effective percentage and the legislative percentage are the same calculations so we would have exactly the same legislative percentage at 3.833%.

At step 4 however, we do not need (n-x)/40 as the property has been in the trust for the whole period before the exit. The actual percentage will therefore simply be 33/40 representing the time from the inception of the settlement to the exit divided by the 40 quarters. Assuming all other information is the same 3.833% x 33/40 will give a percentage of 3.162% and applying this to £100,000 will give an exit charge of £3,162.

Combination of original and added trust property

Where an addition was made of trust property of the same type as the trust property existing in the trust at the time of the settlement, it will be difficult to know if a later exit was made from property in the trust at the creation or from that which was added. There must therefore be rules for identifying which trust property is being exited. For identifiable or traceable property this may be relatively easy, and HMRC accept a first-in-first-out (FIFO) basis or the precise assets distributed if records are reliable. However, for other mingled assets a 'just and reasonable' basis, preferably agreed with HMRC beforehand, is the best approach.

In our example, say the original property, the added property and the distributed trust capital were all cash and were not separated. Like above, the whole amount of the added property is added in arriving at the value of the trust for calculating the percentage. This is therefore unchanged from the previous examples at £575,000. Further, the notional tax, the effective percentage and the legislative percentage are the same calculations so we would have the same legislative percentage at 3.833%.

In step 4, the actual percentage would need to be amended though. There will now be two types of exits; one of the original trust property, using the percentage in the example immediately above of n/40, so 33/40, 3.162%, and one of the added property which will use the percentage in the first illustration of (n-x)/40, (33-17)/40, 1.533%.

Finally, we need to split the trust property to apply these percentages to, on a just and reasonable basis. As we had £700,000 cash at the inception of the trust, and £200,000 cash added, a just and reasonable basis would be 7/9ths applied to the exit representing the existing trust property (at 3.162%) and 2/9ths of the exit representing added trust property (at 1.533%).

This would make the final exit charge:

£100,000 x 7/9 x 3.162% =	£2,459
£100,000 x 2/9 x 1.533% =	£341
Total exit charge	£2,800

Summary

Although the time the added property was in the trust additions will affect the percentage used to charge the inheritance tax on the exit, it will not be taken into account when calculating the value of the trust used for calculating this percentage. Once that concept is understood, the calculation of the exit charge should be easier.

Author details

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