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LIFE INSURANCE SPECIALISTS

IHT on settled property - an overview

Synopsis: Inheritance tax on settled property.

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Settled property

Settlement is defined in section 43(2) IHTA 1984 as...

"any disposition or dispositions of property, whether effected by instrument, by parole or by operation of law, or partly in one way and partly in another, whereby the property is for the time being...

a) held in trust for persons in succession or for any person subject to a contingency; or

b) held by trustees on trust to accumulate the whole or part of any income ......; or

c) charged or burdened (otherwise than for full consideration...........) with the payment of any annuity or other periodical payment payable for a life or any other limited or terminable period; or

d) would be so held or charged or burdened if the disposition or dispositions were regulated by the law of any part of the United Kingdom...........".

The contingency referred to in (a) could be the attainment of a specified age.

Although sometimes the terms “trust” and “settlement” are used interchangeably, it is important to remember that not all property held in trust is settled property. For instance, property held by trustees under a duty to distribute it immediately to selected persons (i.e. bare trusts) is not settled property.

Conversely, in certain circumstances, property which is not held in trust may nevertheless be regarded as settled property, for example, property which is subject to a lease for life if the lease was not granted for full consideration in money or money's worth.

For inheritance tax (IHT) purposes settlements can be either relevant property trusts or trusts not subject to the relevant property regime.

22 March 2006 – an important date for the IHT treatment of settlements

Section 156 and Schedule 20 Finance Act 2006 introduced new IHT rules for settlements. These rules were first announced in the Budget on 22 March 2006 and are effective from that date. These changes represented the most significant change to the IHT regime since its introduction in March 1986.

The rules treat all post-21 March 2006 lifetime settlements other than trusts for the disabled as relevant property trusts for IHT purposes. Prior to that date flexible interest in possession trusts and accumulation and maintenance trusts were treated favourably for IHT purposes in that the relevant property regime did not apply. Different rules apply to some trusts created under a Will.

The relevant property regime

Prior to 22 March 2006, the relevant property regime applied only to settlements where there was no interest in possession (or that were not accumulation & maintenance settlements).

An interest in possession trust is one where one or more of the beneficiaries has entitlement to income. By contrast, there is no interest in possession are where the settled property is held on trusts to accumulate the income or to apply the income at the discretion, normally of the trustees, with or without power to accumulate any surplus.

Trusts under which there is for the time being no individual entitled to an interest in possession are referred to as 'discretionary trusts'. Discretionary trusts have always been taxed in accordance with the relevant property regime.

A lifetime transfer into a discretionary trust (or other trust subject to the relevant property regime) is immediately chargeable to IHT, currently at half of the death rates. IHT will only be payable at the time of the transfer if the settlor's nil rate band is exceeded, taking into account the cumulative total of chargeable transfers in the seven years before the trust was created. Where tax is due, it can be paid either by the transferee or the transferor. In the latter case the value of the transfer is the sum of the transfer plus the tax payable, which means that, if the donor pays the tax, they effectively pay IHT at 25% of the chargeable value of the gift.

Relevant property

Property held in a relevant property trust (i.e. one that is taxed in accordance with the relevant property regime) is known as relevant property. There are two types of charge on relevant property - firstly an anniversary charge, every ten years – this is called the ten-yearly charge or principal or periodic charge - and, secondly, an exit charge (proportionate charge) when the property or a part of it ceases to be relevant property (e.g. on the property leaving the settlement).

Ten-yearly charge

The ten-yearly (or periodic) charge is levied ten years after the creation of the settlement, and at the end of each subsequent ten-year period during the life of the settlement. The anniversary date for the charge is reckoned from the date when the settlement was made, i.e. when property was first included in it (s60 IHTA 1984). The amount charged to tax at each ten-year anniversary is the value - after any business or agricultural relief - of any relevant property comprised in the settlement immediately before that anniversary.

The rate at which the ten-yearly charge is imposed is 30% of the rate which would be charged on a hypothetical chargeable lifetime transfer – Section 66 IHTA 1984.

That rate is one half of the death rate. The amount on which tax is assumed to be charged on this hypothetical transfer is...

- The amount of the relevant property in the settlement on the ten-year anniversary – Section 66(4)(a) IHTA 1984; plus
- The value, at the time they were set up (whether or not that was within the cumulation period), of any other trusts set up by the settlor on the same day (related settlements) - Section 66(4)(c) IHTA 1984; and
- The value, at the time it was put into the trust (whether or not that was within the cumulation period), of any other property in the trust which was not then, and has not at any time been, relevant property, for example because there is an interest in possession in it – Section 66(4)(b) IHTA 1984.

The amount that is assumed to have been charged on previous transfers in the seven years before this hypothetical transfer (the special cumulation) is...

- The settlor's cumulative total of chargeable transfers in the seven years before the creation of the trust; plus
- The amounts in respect of which any proportionate charges have arisen under the settlement in the ten years before the present charge – Section 66(5) IHTA 1984.

These rules are modified in the case of trusts set up before 27 March 1974 and also if there have been distributions from the trust before 9 March 1982 – Section 66(6) IHTA 1984.

Proportionate charge

A proportionate (or exit) charge can arise where property, comprised in a settlement, ceases to be relevant property – Section 65(1)(a) IHTA 1984. The main examples are:

- When the settlement comes to an end;
- When some of the property is distributed to beneficiaries; and...
- When the property becomes excluded property.

Exceptions

There are some exceptions to the charge set out in Section 65 IHTA 1984. Tax is not charged...

- On payments by trustees of costs or expenses which are attributable to relevant property.
- On payments which are subject to income tax in the hands of the recipient.

- When the event giving rise to the charge occurs within three months of the setting-up of a settlement or following a ten-yearly anniversary.

- Where property settled by a person domiciled outside the United Kingdom becomes excluded property and so is no longer relevant property.

- On a decrease of value which results only from a bad bargain made by the trustees, provided that there was no intention to confer any gratuitous benefit by the disposition.

- If the decrease results from the grant for full consideration of an agricultural tenancy.

In addition to these exceptions there is no proportionate charge when property ceases to be relevant property on becoming...

- The property of a charity or other exempt body – Section 76 IHTA 1984; or...
- Held on certain specified trusts for employees – Section 75 IHTA 1984; or...
- Held on the trusts of an approved fund for the maintenance of heritage property - Schedule 4, Part III IHTA 1984.

Measure of the proportionate charge

The measure of the proportionate charge is the amount by which the value of the relevant property in the trust is diminished as a result of the event giving rise to the charge - that is the loss to the trust – Section 65(2) IHTA 1984. If the tax payable is paid out of any relevant property remaining in the settlement the loss will be grossed up so that the amount chargeable includes the tax.

Rate of the proportionate charge – Section 69 IHTA 1984

Rate between ten-year anniversaries

The rate of the proportionate charge is a fraction of the rate that was charged at the last ten-year anniversary. This rate is 30% of one-half of the death rate of tax that would apply to a hypothetical chargeable transfer. The fraction is calculated as one-fortieth for each complete period of three months (quarter) that has elapsed since that anniversary (so it increases as a ten-year anniversary is approached). If the general rates of tax have decreased since the time of the charge at the last ten-year anniversary, the current lower rates are used in the calculation - Paragraph 3 Schedule 2 IHTA 1984.

Rate before first ten-year anniversary

Special rules apply where the proportionate charge falls due before the first ten-year anniversary of a settlement set up after 26 March 1974. In this case the rate of tax is a fraction of a rate calculated by reference to the value of all the property in the settlement at the time of its creation together with the value of any other property in any settlement made by the settlor on the same day. The cumulative total of the settlor's chargeable transfers in the seven years before the setting up of the settlement is also brought into the calculation. This rate is established in much the same way as the rate of the ten-yearly charge.

If the combined total of the value of the property made subject to the settlement plus the cumulative total of chargeable transfers made by the settlor in the seven years preceding the establishment of the settlement didn’t exceed the nil rate band at the time the trust was established, then, regardless of the value of the property exiting the settlement, there will be a nil rate applied. This can be particularly useful for low initial value settled property that acquires a high value prior to exit, e.g. a life assurance policy held in trust.

Settlements not subject to the relevant property regime

Trusts created during lifetime or on death for a disabled person (as defined in the legislation – for further details please see below) are not subject to the above ‘relevant property’ rules.

In addition, a number of other trusts are outside of the relevant property regime. These are as follows…

Interest in possession trusts established before 22 March 2006

These do not fall under the relevant property regime provided that no additional gifts are made after 21 March 2006. However, a change of beneficiary entitled to the interest in possession can result in the trust being brought within these rules if the change occurs after 5 October 2008.

Post-21 March 2006 estate interest in possession trusts

FA 2006 amended section 49 IHT Act 1984 which deals with interest in possession trusts. Pre-Budget 2006 treatment of interest in possession trusts that take effect on or after 22 March 2006 (i.e. where the underlying trust property is treated as being in the estate of the beneficiary entitled to the interest in possession) now applies only in relation to an interest which is one of the following…

- an immediate post death interest (IPDI).
- a disabled person’s interest (DPI).
- a transitional serial interest (TSI).
- All these interests were created by FA 2006.

Trusts for minor children

Under Finance Act 2006, trusts created in a Will or on intestacy for the minor child of the deceased are afforded exemption or partial exemption from the relevant property regime provided certain conditions are met. Where the minor child will become absolutely entitled by the age of 18 as the trust will be a “trust for a bereaved minor” and will not be subject to relevant property (ten-yearly or exit charges) even though the trustees may have power to accumulate trust income during the beneficiary's minority

A trust in a Will in favour of a minor child of a deceased parent that vests the trust capital absolutely in the child between the ages of 18 and 25 will not be a bereaved minor's trust but will be an "age 18 to 25 trust".

If the beneficiary of an 18-25 trust becomes entitled to the capital on or before the age of 18, then no charge to tax will arise at that time. If, however, the trust continues beyond age 18, then at age 18 the trust will become subject to the discretionary trust regime for IHT purposes.

However, there will be no 20% "entry" charge and the trust will be treated as starting when the beneficiary attained age 18 for the purpose of determining the appropriate fraction to be used for the purposes of calculating the exit charge. This means that the maximum exit charge that can arise when the beneficiary becomes absolutely entitled at age 25 is based upon a period of 28 quarter years into the first ten-year trust period. So, the maximum IHT exit charge possible on an 18-25 trust is 4.2% (i.e. 28/40 x 6%).

If the value of the gift to the 18-25 trust on death, plus the cumulative total of chargeable transfers made by the deceased in the seven years prior to death, and the value of any related settlements created on death is less than the nil rate band applicable when the beneficiary becomes entitled, no exit charge will apply.

Accumulation and maintenance trusts established before 22 March 2006

The tax treatment for 18-25 trusts is also generally available for pre-Budget 2006 accumulation and maintenance trusts where the trust was appropriately amended before 6 April 2008 to meet the 18-25 conditions. There is no requirement in such cases for the settlor/testator to be a parent or for the trust to have been created on death.

General exemptions and reliefs affecting pre-22 March 2006 interest in possession settlements

Property reverting to settlor or settlor's spouse/civil partner – Section 53 IHTA 1984 and Section 54 IHTA 1984

There is no tax charge on the termination of an interest in possession if on that termination the settled property reverts to the settlor or the settlor's spouse/civil partner long-term resident in the UK. The exemption does not apply if the settlor or the settlor's spouse/civil partner acquired the reversionary interest for a consideration in money or money's worth.

The exemption also applies where, within two years of the settlor's death, the property reverts to the settlor's widow or widower long-term resident in the UK.

Excluded property – Section 53 IHTA 1984

There is no charge where the property in which the interest in possession has come to an end is excluded property.

From 6 April 2025, whether foreign property comprised in an interest in possession settlement is excluded property (IHTM04251) depends on the circumstances of the settlor and the person with the interest in possession.

At times, on or after 6 April 2025, where there is a living settlor and both the settlor and the person with the interest in possession are not long-term UK residents (IHTM47000), foreign settled property will be excluded property.

Where the settlor dies on or after 6 April 2025, if the settlor was not a long-term UK resident immediately before their death, then foreign property comprised in the settlement will be excluded property at times where the person with the interest in possession is not long-term UK resident.

Where the settlor has died before 6 April 2025, settled property situated outside the UK is excluded property if the settlor was domiciled (IHTM13000) outside the UK at the time the property was settled and neither the settlor nor their spouse/civil partner had the current interest in possession. Otherwise, where the settlor has died before 6 April 2025, the long-term UK residence status of the person with the interest in possession is not relevant.

It should be noted that the property would cease to be excluded property if the trust funds situated abroad are sold and UK assets are acquired.

There is no charge where the settled property became comprised in the settlement before 30 October 2024, if, immediately before 30 October 2024, the settled property was excluded property, the person whose interest comes to an end became beneficially entitled to the interest before 30 October 2024, and immediately before the person's interest in possession in it comes to an end, the settled property was situated outside the UK and was not overseas property with value attributable to UK residential property, or a holding in an authorised unit trust or a share in an open-ended investment company.

That is, where non-UK assets were comprised in a settlement and were excluded property immediately before 30 October 2024, these will not be subject to charge when the interest in possession that subsisted at 30 October 2024 comes to an end or on the death of the interest in possession beneficiary (IHTM47022).

Example

Preta made an interest in possession settlement in March 1997 when she was UK domiciled. The life tenant of the settlement is Becky. The property in the settlement is foreign property. Becky is a long-term UK resident from 6 April 2040 to 5 April 2063. Preta is a long-term UK resident from 6 April 2025 to 5 April 2063. If Becky's life interest comes to an end during her lifetime, she is treated as making a potentially exempt transfer (PET) (IHTM04072) of the value of the settled property.

If the PET is made between 6 April 2025 and 5 April 2063, the PET will not be excluded property, and will be chargeable if Becky dies within seven years, even if she is not a long-term UK resident at the time of her death. This will still be the case if the seven-year period ends after 6 April 2063. If the PET is made after 6 April 2063, it will be a PET of excluded property (as both Preta the settlor and Becky the life tenant are now not long-term UK resident).

Please see [IHTM47051 - Long-term UK residence test: Foreign settled property: Qualifying Interests in Possession - HMRC internal manual].

Surviving spouse exemption - Paragraph 2 Schedule 6 IHTA 1984

Where estate duty was paid on the death of one spouse before 13 November 1974 on property in which the other was given a limited interest, for example for life or widowhood or widowerhood, the property was usually exempt from estate duty on the death of the survivor.

In such a case, when the survivor dies, or the interest comes to an end or is disposed of, there will be no charge to IHT on the settled property if it would have been exempt from estate duty on the survivor's death.

Relief for successive charges

If a chargeable transfer is made within five years of a previous transfer of settled property, relief is available by reducing the tax on the later transfer on a sliding scale from 100% of the tax on the later transfer if made within one year to 20% for transfers made in the fifth year after the first transfer (Section 141 IHTA 1984).

Property held on special trusts

Property held on certain specified types of discretionary trust ('special trusts') does not rank as relevant property – Section 58 IHTA 1984. This means that these special trusts are not liable to the ten-yearly and proportionate charges.

These special trusts are...

- Property held for charitable purposes.
- Property held in a fund maintained by a trade or professional association provided that the purpose of the fund is solely or mainly to compensate for or relieve loss or hardship which, through the default of members, is incurred by others.
- Registered pension schemes and registered personal pension arrangements are generally exempt from the charges on settled property. But the tax may be payable if...
    - A member gives up part of their pension in order to provide for a person other than a spouse/civil partner;

- A member has the power to determine who shall receive a benefit on their death;
- A benefit on the member's death is payable to their personal representatives as part of their estate; or
- A sum payable under the scheme is made the subject of a further settlement.

So, to avoid the ten-year anniversary charges and the exit charge, occupational pension schemes and personal pension schemes are set up under discretionary trusts. Death benefits payable under such schemes are normally, therefore, free of IHT.

Although, note that, from 6 April 2027, most pension funds will fall into the estate for IHT purposes.

Employee trusts

Relief from the ten-yearly and proportionate charges is also available to property held on discretionary trusts under which, for any defined period, the property can be applied only for the benefit of employees in a particular occupation or of a particular firm, or the relatives or dependants of such employees.

Tax is charged when property ceases to be held on employee trusts or when the trustees make a disposition which reduces the value of the property so held. Distributions to the employees or their relatives or dependants are normally exempt. In addition, no tax charge arises on an interest in possession in the settled property if the interest extends to less than 5% of the property – Section 86(4)(b) IHTA 1984.

Trusts for disabled persons

Property transferred into a settlement after 9 March 1981 which is held on discretionary trusts primarily for the benefit of a person who by reason of mental disorder is incapable of administering their property (or managing their affairs) or who is in receipt of an attendance allowance, is treated for the purposes of IHT as if the disabled person had an interest in possession in that property – Section 89 IHTA 1984.

So, distributions out of such property to the disabled person are not taxable.

When the property ceases to be held on the discretionary trusts (whether during the lifetime of the disabled person or on their death) a charge would then arise on the basis that the deemed interest in possession has terminated.

This favourable IHT treatment has now been extended to interest in possession trusts for disabled persons regardless of when the trust was created, as well as to trusts created by someone who expects to become disabled in the future and establishes a trust to provide for their future needs (subject, in all cases, to the trust meeting various conditions concerning the application of income and capital during the disabled person's lifetime).

Temporary charitable trusts

Settled property which, for a limited period however defined, can be applied only for charitable purposes is also excluded from the ten-yearly and proportionate charges. Instead, tax is charged when property ceases to be held for charitable purposes or when the trustees make a disposition which reduces the value of the property so held. But any application of the property for charitable purposes does not give rise to a charge.

Maintenance funds for historic houses

Relief from the full discretionary trust charges is also available for trusts set up for the maintenance of historic buildings.

Survivorship clauses

There is a relief from the settled property charges when a survivorship clause provides that a gift by Will or under a settlement shall take effect only if the beneficiary survives a specified person, for example the testator, for a short-specified period. The relief applies where the specified period is not more than six months.

Under the relief, any trusts during the specified period are disregarded and the gifts which actually take effect at the end of the specified period are treated as having done so immediately on the death – Section 92 IHTA 1984. Such a clause is normally included in modern Wills to avoid the same estate being taxed twice should the beneficiary die soon after the testator's death.