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STEP MODEL CLAUSE FOR CHARITABLE LEGACIES

Following consultation with HMRC, the Society of Trust and Estate Practitioners (STEP) has published a model clause that can be used by persons wishing to leave a legacy qualifying for the reduced 36% rate of inheritance tax where 10% or more of, broadly, the chargeable estate, is left to charity on death.

The clause ensures the minimum amount required is gifted to charity in order to qualify for the reduced rate of inheritance tax under Schedule 1A Inheritance Tax Act 1984.

HMRC's online charitable legacy calculator can be used to calculate the amount of the legacy that would be left to charity using the model clause. The actual amount of the legacy on the person's death will, however, depend on the value of the estate at death and the exemptions, reliefs and nil rate band then available.

COMMENT

Ensuring that 10% of an unknown net quantity is left to charity can be complex – especially where the estate is made up of several component parts. The new model clause assists the drafter by overcoming the issues involved and use of the clause will avoid testators having to keep their estates constantly under review to ensure that the 10% condition continues to be met as asset values change.

ACT NOW TO AVOID A CHILD BENEFIT TAX TRAP

The high income child benefit tax charge came into effect on 7 January 2013. Broadly, a taxpayer may be liable to this new tax charge if they, or their spouse, civil partner or partner (who is not married but who is living with them) have an individual income of £50,000 or more and one of them receives child benefit. If both have an income of £50,000 or more, the charge will apply solely to the partner with the highest income.

HMRC says that a large number of families are affected by the high income child benefit tax charge and have until 5 October to register for self-assessment to enable HMRC to administer the tax charge. Failure to do so could result in a penalty for not submitting a tax return on time. As such HMRC is writing to around 2 million higher rate taxpayers reminding them that if their income is over £50,000 and they or their partner received child benefit in 2012/13, they will be subject to the high income child benefit tax charge.

HMRC estimates show that approximately 600,000 people are affected by the charge and 400,000 chose to opt-out from receiving child benefit to prevent being subject to the charge.

COMMENT

This is a good time to remind any clients who may be affected by the high income child benefit tax charge to register for self-assessment to avoid being hit with a penalty – and equally important to advise any other clients to register for self-assessment should they be required to do so for other reasons.

RAISING THE STAKES ON TAX AVOIDANCE

The Budget 2013 highlighted the Government's intention to clamp down on high-risk promoters and users of tax avoidance schemes that are likely to fail. As a result, the Government has published a consultation document which seeks views on proposals on tax avoidance schemes, and on an extension to the Disclosure of Tax Avoidance Schemes (DOTAS) rules.

This particular consultation document, "Raising the stakes on tax avoidance", follows on from the 2012 consultation, "Lifting the lid on tax avoidance schemes".

Broadly, this consultation focuses on two main issues. The first proposes a new set of obligations for high-risk promoters, their intermediaries and users. The second is to encourage users of avoidance schemes to settle their tax affairs after similar cases have been lost in Court or Tribunal. The Government also seeks views on a proposed extension to the prescribed information to be provided under the DOTAS rules.

The key objectives of the consultation include:

- deterring the use of avoidance schemes from the outset
- changing the behaviour of high-risk promoters and those who are potentially high-risk

- forcing high-risk promoters to provide details of their products to HMRC
- requiring high-risk promoters to inform their clients of the consequences of their high-risk designation
- establishing a higher threshold for reasonable excuse and reasonable care
- ensuring that the high-risk promoter's clients understand the risks and consequences of engaging in these schemes, including the new follower penalties (ie. penalties in avoidance cases).

The consultation closes on 4 October 2013.

COMMENT

The Government's intentions have been clear in its battle to clamp down on tax avoidance. Not only has this year seen an increase in these types of case but it has become evident that more people have faced prosecution than ever before. With this in mind, clients and advisers alike should be fully aware of their legal and tax responsibilities – in essence it provides you with the perfect opportunity to advise clients about tax-effective schemes that are acceptable to the Government and HMRC.

THE INHERITANCE TAX TREATMENT OF EMPLOYEE BENEFIT TRUSTS

Over the last few years, HMRC has mounted several challenges to the tax benefits of Employee Benefit Trusts (EBTs). These have related to:-

(i) the deductibility or otherwise of employer contributions;

(ii) the assessability or otherwise of employees when contributions are made or benefits paid; and

(iii) the inheritance tax (IHT) treatment of such trusts.

Points (i) and (ii) have, to a large extent, been dealt with by the introduction of the disguised remuneration rules. However, the IHT issues of such trusts are not covered under these rules.

As far as IHT is concerned, in general, provided the trust satisfies the EBT conditions in section 86 IHT Act 1984, the IHT treatment of EBTs will be as follows:-

(i) contributions will not be transfers of value
(ii) the trustees will not be subject to periodic and exit charges

In this respect, it is clear that HMRC believes that some companies have been seeking to take advantage of the preferential rules mentioned above for EBTs in a way which is outside the intent of section 86.

As part of its rewrite of the inheritance tax manual HMRC has now released details of its practice on the application of the IHT provisions to EBTs.

The main features of this practice are that:-

- EBTs qualify for relief from inheritance tax if they meet certain conditions set out by HMRC in the update to its manuals.

- HMRC acknowledges that the term "employee benefit" trust is used to describe a number of different sorts of trust, although they are generally discretionary trusts.

- In general an employer sets up an EBT as a vehicle used in a scheme to reward and motivate employees. The benefits may be pensions, sick pay, a share of profits or entitlement to shares in the employer company.

The conditions set out in section 86 IHT Act 1984 do not prevent an EBT from qualifying for special relief if the trustees, or some other person, have the power to alter the trusts, so that persons outside the specified classes in section 86 IHT Act 1984 could benefit.

Nor does it matter if the existing trusts provide that other persons may benefit in the future.
It is the trusts that actually apply to the trust property at the time of the inheritance tax charge that are important and must be considered.

However, if the trusts are altered in such a way that they no longer satisfy the requirements of section 86 IHT Act 1984, the relief from the periodic and exit charges would no longer apply. An example of this could be the creation of a reversionary interest.

Where a trust is altered in such a way that the relief no longer applies the trust becomes a relevant property trust (see IHTM42161) unless it falls within one of the categories of other trusts outlined in the updated manual.

COMMENT

The inheritance tax reliefs offered to EBTs are valuable. Companies establishing such trusts to take advantage of these reliefs should carefully take account of HMRC's most recently published views on when trusts qualify for relief and when they may lose such relief.

THE LATEST STATISTICS FROM HMRC CONFIRM THE STEADY RECOVERY OF THE INHERITANCE TAX TAKE

HMRC has published its annual statistics on inheritance tax (IHT) receipts, which estates pay IHT, the use of tax reliefs and the assets left on death by these estates.

Receipts data is available for the 2012/13 tax year as this data is based on cash received by HMRC. Other data relating to the composition of estates, the use of reliefs and the tax due on estates is provided for the 2010/11 tax year.

The latest figures show that, on an annual basis, receipts have risen by 8% in 2012/13, with transfers on death accounting for £2.96bn of the IHT take in 2012/13 compared to £2.8bn in 2011/12. While this is still some way below 2008/09 levels, the latest figures confirm that the IHT take (which is slightly up on the 7% year-on-year increase observed in 2011/12) is steadily increasing once again.

The recovery in property prices, household savings and equities will have contributed to the improvement but the freeze in the nil rate band (which has been £325,000 since April 2009) has undoubtedly dragged more estates over the IHT threshold and potentially into paying IHT.

Other points worth noting are:

- A total of 15,584 estates paid tax in 2010/11 – this equates to approximately 3% of all deaths in that year.

- The composition of taxpaying estates varies depending on the value of the estate, with the proportion of cash decreasing and residential property values increasing as the value of the estate rises. However, as the estate value increases further, the proportion of securities increases at the expense of residential property and cash.

- The figures also show that fewer estates pay relatively more tax the higher up the estate band they are with £1.8bn (i.e. 68%) of all the inheritance tax paid in 2010/11 having been paid by the relatively small percentage of estates worth in excess of £1m.

COMMENT

Up until 2007/08, IHT receipts had been climbing steadily, reflecting increases in property prices and other asset values. However, receipts declined in 2008/09 and 2009/10 partly due to the introduction of the transferable nil rate band but also due to falling house prices in the second half of 2008 and through most of 2009. The latest figures, which show that the IHT take is increasing once again, will be of interest to advisers operating in a fee-based environment given that the wealthiest clients pay the most IHT and have more complex financial needs – consequently requiring specialist services that can be charged at a premium.

UPDATED GUIDANCE ON DISCOUNTED GIFT TRUSTS

HMRC has published Revenue & Customs Brief 22/13 which provides updated guidance on the valuation of a Discounted Gift Trust (DGT), based on a relevant property trust, for the purposes of the ten-year anniversary charge, and the calculation of transfer values when a DGT is set up.

Following the inheritance tax changes to the taxation of trusts set up on or after 22 March 2006, most types of trust used for DGTs will be relevant property trusts and, as such, be subject to the associated charges and reporting requirements for these types of trust. In light of this, the Brief is aimed at trustees of DGTs as well as providers who may wish to provide relevant values to their customers when the trust is established and at subsequent ten-year anniversaries.

Ten-year anniversary charges

Under the terms of a DGT the settlor will have typically settled a bond or series of policies from which they have retained the right to a series of regular cash payments. While the bond or policies are relevant property for inheritance tax purposes, the retained rights are normally held upon bare trust for the settlor and as such are not relevant property.

For the purposes of the ten-year anniversary charge, the value of the relevant property needs to be established and a number of factors will need to be taken into account.

Essentially, the value of the relevant property is its open market value – not including the rights retained by the settlor. This is based on the right to receive the whole of the underlying bond following the death of the settlor taking account of the payments the settlor is entitled to receive and the delay between the valuation date and the death of the settlor when the amount would be paid.

Analysis of sales indicate that open market purchasers take a prudent approach and do not factor in any growth in the capital value of the asset even though the settlor's retained rights are not limited to income produced by the fund and, in some cases, it is possible for the settlor's retained rights to exceed the growth. The value will differ depending on how the retained rights are structured. However, the HMRC view is that a prudent approach would be taken so as to not factor in any growth but would allow for the delay until the fund will be available – i.e. on the settlor's death.

In addition, the settlor's state of health would also need to be considered. This can provide some complications because, if a normal life expectancy is assumed then, unless there is clear evidence that the settlor is terminally ill, the open market purchaser may have to wait for some time to realise their investment if the settlor survives longer than expected. This open market practice leads to the view that the age to be used in the valuation is the age next birthday of the settlor with no adjustment for the state of their health. However, this could understate the value, especially in cases where the settlor is terminally ill, and so the fund is likely to be realised imminently. In addition, this creates a risk that tax will be lost as the valuation will be lower.

HMRC states that there are three options to overcome the risk of understating the value:

(i) Obtain evidence of the settlor's health at the ten-year anniversary – although this could be costly and give rise to an administrative burden.

(ii) Complete a valuation based on the settlor's age next birthday but, should death occur within two years of the ten-year anniversary, HMRC can review the position to ensure the correct amount of tax was paid. Evidence of the settlor's state of health may be required retrospectively which could prove to be difficult.

(iii) Complete a valuation based on the settlor's age next birthday from when the trust was established and add ten years for each ten-year anniversary. As it is likely that the case was underwritten at outset no further medical evidence would be required and this would provide certainty to the trustees that the tax position was finalised.

HMRC considers the third option to be most practical. Not only is the administrative burden minimised but it also protects HMRC from potential loss of tax.

The valuation is required to be carried out on an open market basis in line with s.160 IHTA 1984. In order to provide some certainty, HMRC will accept valuations that are calculated using the same mortality basis as is then in use in valuing the transfer when a DGT is effected, replacing select with ultimate mortality.

Note that for jointly settled DGTs, the value of the fund will be treated as comprised in separate settlements in the proportion that the original funds were provided by each settlor.

Examples are contained in the Revenue and Customs Brief 22/13.

The transfer value when a DGT is set up

HMRC issued a Technical Note in May 2007 which dealt with the transfer of value that arises when a DGT is set up. The Note also set out the valuation basis which is acceptable to HMRC in establishing the value transferred. Subsequently amendments to the valuation rate of interest have been made and are summarised in the inheritance tax manual at IHTM 20656.

However, following the 'Test-Achats' case, the use of gender as a factor in setting insurance premiums is no longer allowable as from 21 December 2012. Therefore, the valuation basis needs to be amended to reflect this significant change in how life assurance premiums are calculated. Prior to this case, actuarial calculations would have taken account of gender (primarily the view that women tend to live longer!) when valuing the amount transferred. However, in the 'Test-Achats' judgment, the European Court ruled that, from 21 December 2012, the 'unisex rule' contained in Article 5(1) of Council Directive 2004/113/EC must be applied to equalise the calculation of individuals' premiums and benefits in new life assurance contracts.

Following the removal of gender as a factor in setting life assurance premiums the mortality basis used by HMRC needs to be altered to reflect this change in open market premium rates. At the same time it is an appropriate time to reconsider the current interest rate assumption within the calculation. Further details are covered in the Revenue & Customs Brief.

Elderly lives

In the May 2007 Technical Note referred to in the previous section, HMRC expressed the view that a discount cannot be given for somebody aged 90 or more on a true or mortality rated basis. This is on the basis that, in general, life assurance cover is not available for people who are older than this and it is HMRC's considered opinion that no one would buy the retained rights if they could not also buy insurance against the risk of early death. If there would, in practice, be no buyer then the settlor's retained rights could have no value. This would mean that there would be no discount.

In Revenue and Customs Brief 22/13 it is stated in connection with ten-year anniversary charges that an open market purchaser would not be concerned to insure the life of the settlor. Here the concern would be in establishing the settlor's life expectancy which can be determined by the settlor's age, gender and state of health. This means the "90 years of age" rule does not apply and is borne out by an HMRC example which calculates the ten-year anniversary charge for a settlor aged 92 at that time and ascribes a value to their retained rights.

This confirmation is welcomed as it has generally been assumed that the "90 years of age" rule would also apply to the ten-year anniversary charge calculation in which case the retained rights would have no value and so could be ignored.

COMMENT

Advance guidance such as this is always likely to be welcomed as providers and trustees can prepare themselves well in advance of a ten-year anniversary charge potentially arising.

FORM 41G TRUST – A REMINDER

HMRC Trusts & Estates is receiving a number of 41G forms in cases where a trust is not expected to receive trust income or make chargeable gains. This in turn can lead to HMRC issuing a SA900 Trust and Estate Tax Return even where there is no requirement for the trustees to complete it.

Form 41G is used to notify HMRC that a trust has been created. However, the form does not have to be completed in all cases. Below we provide a reminder of when the form should be completed.

HMRC should be notified as soon as a new trust (other than a bare trust) is created if the trustees expect the trust to:

- receive income
- make chargeable capital gains (profits) from the sale of assets - such as shares, buildings or land - within the next tax year

For an existing trust, if the trustees start receiving income or making chargeable gains they must notify HMRC by 5 October following the end of the tax year (ie. 5 October 2013 for the 2012/13 tax year).

A Form 41G is not required if the trust does not/is not going to receive any income or make any chargeable gains.

COMMENT

So, in cases where trust assets include, say, a portfolio of stocks and shares a Form 41G will always be required. The position is, of course, simpler where the sole trust asset is an investment bond as the trustees will not be required to notify HMRC that a trust has been created – making the trust administration less onerous.

INCOME WITHDRAWAL RATE FOR SEPTEMBER 2013

The appropriate gilt yield, used to determine the 'relevant annuity rate' from HMRC's tables for an adult member commencing income withdrawals (or reaching an income withdrawal review date), in September 2013 is 3.0%.