

ISSUES FOR U.S. CITIZENS RESIDING IN THE U.K.

This paper was originally delivered on 24 April 2009 to the Fifth Annual International Estate Planning Institute (sponsored by the New York State Bar Association (NYSBA) and Society of Trust and Estate Practitioners (STEP).) It has since been amended on 19 May 2009 to take account of the changes introduced by the UK Budget 2009. In particular, the entire section on making use of excess foreign tax credits through UK pension planning has been removed due to the UK Budget changes.

1. INTRODUCTION

In my paper yesterday I gave an overview of the UK tax treatment of UK resident non-domiciled individuals ('RNDs'). The vast majority of US citizens who are resident in the UK are likely to be treated as RNDs from a UK tax perspective. I shall use the term US RNDs to refer to US persons who are UK resident but not domiciled there.

What I would like to do this morning is to focus on some of the key issues that affect US citizens who are resident in the UK. These are:

- The Finance Act 2008 changes to the remittance basis of taxation and the new £30,000 remittance basis charge.
- The impact of the new regime on trusts.
- UK tax issues for grantor trusts where the grantor moves to the UK.
- Reduction in capital gains tax rate to 18%.
- An overview of the key UK inheritance tax rules that the US estate planner needs to be aware of when advising a US/UK couple.
- Benefits of excluded property trusts for US RNDs.
- Potential impact of the UK relevant property regime on ILITs and other trusts.
- Nightmare on Planning Street: interaction of US and UK tax rules using a case study.

2. FINANCE ACT 2008 CHANGES TO THE REMITTANCE BASIS OF TAXATION AND THE £30,000 CHARGE

US RNDs are a subset of RNDs and so in order to consider the issues for US RNDs, it is first necessary to consider the post 5 April 2008 tax regime applicable to RNDs generally. Subsequently I shall focus on the specific issues affecting US RNDs.

Application to RNDs generally

- 2.1 RNDs are entitled to claim the remittance basis of taxation. The remittance basis of taxation entitles the taxpayer to be subject to UK taxation on his UK source income and gains and his foreign income and gains to the extent that they are remitted to the UK. Subject to the exception referred to below, if a RND chooses not to make a claim to be taxed on the remittance basis, all of his worldwide income and gains, wherever arising and whether brought into the UK or not, will be taxed in the UK (subject to the provisions of any double tax treaty). Therefore, it is important for RNDs to decide whether or not to claim the remittance basis.

- 2.2 RNDs who have been resident in the UK for at least 7 out of 9 tax years will have to pay the £30,000 charge if they elect to be taxed on the remittance basis. However, the seven out of nine year rule is often a trap for the unwary and in an extreme case the charge could commence after just over five actual years of presence in the UK¹.
- 2.3 RNDs with unremitted foreign income and gains of less than £2,000 will automatically be subject to the remittance basis of taxation and will continue to benefit from their personal allowances and capital gains tax exemption and will not have to pay the £30,000 charge. Therefore RNDs with relatively modest amounts of foreign income or gains should consider now whether to remit all of their worldwide income and gains apart from £2,000.
- 2.4 If an RND decides to claim the remittance basis for the tax year 2008/09, the claim must be made by 31 October 2009 if completing a paper tax return, or by 31 January 2010 if completing a return on-line. The RND will have to make a payment by 31 January 2010 of £45,000, being the £30,000 charge plus £15,000 as a payment on account for the tax year 2009/10, assuming he anticipates that he will be UK resident in that tax year and claim the remittance basis. During the tax year that the RND has made the claim, he or she will not be entitled to the UK personal tax allowances, or the annual exemption for capital gains. It will therefore be necessary to calculate whether an election is appropriate.
- 2.5 RNDs will be required to “nominate” the source of unremitted foreign income or gains on which the charge will be paid. At present, we do not know how much information will have to be given to HMRC. However, once the source has been nominated, it will be important to ensure that none of the monies from that source are remitted to the UK, either deliberately or inadvertently. If the nominated income or gains are remitted, it appears that no tax charge arises. However the practical reality is different; the remittance of the nominated amount will be deemed to be a remittance of the RNDs other foreign income or gains. Further, ordering rules will apply to determine what is remitted in a tax year which, it appears, will affect the present tax year and all future tax years as well. The ordering rules apply to the extent of the actual remittances of income or gains and they operate on a “worst first” basis, treating income as being remitted prior to capital gains and capital.
- 2.6 Due to the uncertainty of the ramifications of remitting the nominated amount (in full or in part) we have recommended to our (non-US) RND clients that a separate, interest-bearing account is set up outside the UK to provide the RND with a source of income which will never be remitted. If the amount in this account is relatively small this should not create any inconvenience. All that is necessary is that the relevant account should generate some interest; £1 by the end of the tax year will be sufficient. The legislation provides that where the source of income or gains is insufficient to create a tax charge of £30,000, the charge is nonetheless increased to £30,000.
- 2.7 Provided the RND pays the £30,000 charge direct to HMRC from a foreign bank account (not being the nominated source), the payment will not itself be treated as a remittance.
- 2.8 Where more than one member of a family is potentially subject to the remittance basis charge, it will be worth considering whether the family’s affairs can be restructured to limit the payment of the charge to one family member.
- 2.9 There are new rules relating to capital losses. Before the new regime, losses on foreign assets were not available. From 6 April 2008, RNDs can make an election so that their foreign losses are available to them. The election has to be made in the first year that the RND elects to be taxed on the remittance basis and, once made, it is irrevocable. Losses are then set against chargeable gains in a specified order: first against unremitted gains, then remitted gains and finally UK gains.

1. For example, say that an individual arrives in the UK on 1 April 2009. He will be subject to the £30,000 remittance basis charge from 6 April 2014 even though he will only be in the UK for 5 years and 5 days at that point!

The ordering rules apply to both foreign and UK losses. Previously UK losses could only be set against UK gains. Careful consideration of the RND's UK and foreign loss position will need to be undertaken before deciding whether an election is likely to be beneficial. It will not be beneficial in all cases to make the election as it may result in UK losses effectively being wasted.

- 2.10 There are ordering rules if RNDs remit monies from mixed accounts – broadly monies giving rise to the highest rate of tax are deemed to be remitted first. RNDs should therefore consider opening a number of different bank accounts in order to segregate different types of income (i.e. income which carries tax credits from that which does not) and the proceeds of sale of investments sold at a loss, no gain or a gain. This will enable them to choose in which order they remit monies to the UK to give themselves the most favourable tax result.
- 2.11 There is a new 50% income tax rate on income above £150,000 from 6 April 2010 onwards.

Specific issues for US RNDs

- 2.12 Clarification is still awaited from the IRS as to whether or not the £30,000 payment will be available as a credit against US tax. Because US persons are taxable on their worldwide income and gains in the US, claiming the remittance basis in the UK will only be beneficial to the extent that the UK effective rate of tax that would have been paid on that income is higher than the US effective rate.
- 2.13 With non-US RNDs, the decision on whether to pay the £30,000 charge is based on simple maths: will the non-UK income exceed £75,000 or will the non-UK capital gains exceed £166,667? Where the RND is a US person, the issues are much more complex. The issues arising for US RND's are as follows:-
- Will the IRS grant a credit for the £30,000 charge?
 - If so, should he pay it and will the credit be available in full?

- 2.14 At the time of preparing this paper, the IRS have not yet agreed to grant a credit. The US and the UK are renegotiating the income tax treaty and it is likely that the issue regarding the credibility of the £30,000 charge from the US will be decided during the course of these negotiations.
- 2.15 If the IRS allow the credit, it might seem at first glance that the US RND taxpayer will pay the higher of the two country's effective tax rates and that double taxation should be avoided under the treaty. If only life was so simple! Unfortunately, the US and the UK treat common forms of income and gains differently for tax purposes. Examples of this include:

- Interest earned on US municipal bonds are tax exempt in the US but are subject to income tax at 40% in the UK. Therefore, if for example a US RND was nominating £75,000 of interest from a municipal bond to bear the £30,000 tax charge, there would be no US income tax liability on that income to credit it against.
- As I understand it, the US rate of tax on disposals of collective investments in US mutual funds is 15%. Under UK rules such disposals are taxed as offshore income gains at the income tax rate of 40% unless the fund is a 'reporting fund' for UK income tax purposes.
- Remittances of US qualifying dividends as with remittances of all non-UK dividend income by remittance basis users are taxed at 40% in the UK. Such dividends are taxed at an effective rate of 25% in the UK in the hands of non-remittance basis users.

2. 'Reporting fund' fund is a new term for offshore funds from a UK perspective, the returns on which are subject to capital gains tax treatment. It replaces the term 'distributor status fund' as part of the changes to the offshore fund rules. A number of US focused investment managers in London provide access to US mutual funds that have obtained reporting fund status for UK purposes. Of course, as always, care needs to be taken not to let the tax tail wag the commercial dog but where there is a sound investment rationale for investing in a particular mutual fund in any event, the fact that it has reporting fund status is a significant attraction when compared with a fund of equal commercial outlook that does not have reporting fund status.

- In the UK, a principal private residence that is occupied as such or deemed to be occupied as such is fully exempt from UK capital gains tax. There is only a restricted exemption available in the US.
- 2.16 The planning outlined at sub-paragraph 2.6 is not likely to be suitable for US RNDs because it seems likely that if the IRS are going to give a credit, they will want the £30,000 to have borne UK tax in respect of a 'real' amount of income, not just a nominal amount.
- 2.17 Ultimately whether a US RND chooses to pay the £30,000 charge will depend on the nature of his/her assets and his/her sources of income. In depth calculations by US/UK specialist accountants will be needed to determine if paying the £30,000 will result in overall US/UK tax savings.
- 2.18 Although non-US RNDs can delay making a decision on whether to pay the £30,000 charge for the UK tax year 2008/09 until 31 January 2010, this is not so for US RNDs. In fact US RNDs may need to have made this decision as early as 15 April 2009. This is because making a claim for part or all of the £30,000 charge on a 2008 US tax return may involve "re-sourcing" (under the UK/US double tax treaty) US income as foreign income in order to claim credit for the £30,000 charge, this in turn may reduce the amount of US tax owed at 15 April 2009.

3. IMPACT OF THE NEW REGIME ON OFFSHORE TRUSTS

- 3.1 RND beneficiaries (including the settlor) who receive a capital distribution from an offshore trust will be subject to UK tax on capital payments received in the UK which are matched with trust gains. However, capital payments which are kept out of the UK will not be taxed on a RND beneficiary who elects to be taxed on the remittance basis, even if matched with UK gains.
- 3.2 The reduction in the capital gains tax rate to 18% is clearly significant. With the proposal announced in the 2008 Pre-Budget Report to increase the top rate of income tax to 45% from 6 April 2011, it appears there is a clear benefit in investing for capital gains over income.

Therefore, trustees will need to consider the impact of the new tax regime on investment policy, although, as always, any decisions regarding investments should not be driven solely by tax.

- 3.3 Trustees are able to make an irrevocable election to rebase trust assets held on 6 April 2008. Where an election is made, any trust gains that had accrued, but had not been realised before 6 April 2008 will not be taken into account for the purposes of matching post-5 April 2008 capital gains to capital payments made to RND beneficiaries. The election effectively re-values trust assets to their market values as at 5 April 2008.
- 3.4 If the trustees decide it is appropriate to make the election, it must be made by 31 January following the tax year in which a capital payment is made to a UK resident beneficiary or when part of the trust fund is transferred to a new settlement. If the election is not made on either of these occasions, the rebasing election opportunity will be lost. Therefore, prior to making a capital payment or transferring trust assets to a new settlement, trustees will need to consider whether or not it is appropriate to make the rebasing elections. It is important to remember that the election will not be made on an asset by asset basis but will apply to all assets of the trust and its underlying companies.
- 3.5 HMRC have now published a form on which trustees can make the election. The trustees will be required to provide the name and date of the settlement together with their full names and addresses. It remains to be seen what, if any, further use HMRC will make of this information.
- 3.6 Originally, the payment of fees and commissions to professional advisers would have resulted in a remittance of foreign income and gains if the fees related to services provided from the UK and were paid out of foreign income and gains. This has now been relaxed and, provided the services provided in the UK relate wholly or mainly to property situated outside the UK, and provided the payment is made to a non-UK bank account, the fees paid will not constitute a remittance. HMRC have confirmed that "wholly or mainly" means in excess of 50% and whether the condition is met will be judged by reference to work done (normally time spent).

It does seem extraordinary that, as a result of this legislation, HMRC have required UK professionals who advise overseas trustees to open foreign bank accounts.

- 3.7 A credit mismatch issue arises for US trusts with UK resident beneficiaries because the trust is subject to US income tax on an arising basis on trust gains whereas the US RND beneficiaries of the trust are only subject to UK tax on a remittance of a benefit that is matched with the trust gain. There is no easy answer to this although I have had experience of HMRC by concession allowing a credit for up to half the US income tax paid. In some cases, the appropriate solution to this may be to make the trust dual US and UK resident.

4. ISSUES FOR US GRANTOR TRUSTS WHERE THE GRANTOR/SOLE TRUSTEE MOVES TO THE UK

- 4.1 In my experience, it is common for US persons to be the trustee of their own grantor trust. Whereas for US tax purposes, a grantor trust may just be “another pocket in the pants” of the grantor of the trust, this is not so for UK tax purposes. There are two specific issues in this regard that need to be flagged:
- The remittance basis of taxation does not apply to trustees. Therefore if a US person who is a grantor and sole trustee of his trust moves to the UK it will make the trust resident from a UK income tax and capital gains tax perspective with no remittance basis available. The trustees are treated as a continuing body of persons for UK income tax and capital gains tax purposes and are not entitled to the remittance basis of taxation. Hence they are subject to UK taxation on an arising basis.

- There is a capital gains tax exit charge where a UK resident trust ceases to be UK resident. Therefore if the US grantor and sole trustee of the trust decides to move back to the US, this will trigger a capital gains tax charge where the trustees are deemed to have disposed of all their assets at market value at the date of cessation of residence. It will not be possible to avoid the exit charge by winding up the trust prior to ceasing UK residence as this also causes a deemed disposal for capital gains tax purposes.

- 4.2 The practical way to deal with this is to appoint at least one non-UK resident trustee before the grantor moves to the UK so that under the UK income tax and capital gains tax trustee residence rules, the trust is not deemed to be UK resident provided that the grantor was not UK resident, not UK ordinarily resident and not UK domiciled when he created the trust³.

5. REDUCTION IN CAPITAL GAINS TAX RATE TO 18%

Prior to 6 April 2008, the UK capital gains tax rate was 40%. This compared favourably to the US income tax rate on long term capital gains of 15% and there was certainly benefit in planning to avoid or defer UK capital gains tax for US RNDs. Now, the saving is only 3% and so this needs to be factored in when assessing the merits of any proposed UK capital gains tax planning for US RNDs.

3. Section 474 Income Tax Act 2007 and section 69 Taxation of Chargeable Gains Tax Act 1992.

6. AN OVERVIEW OF THE KEY UK INHERITANCE TAX RULES THAT THE US ESTATE PLANNER NEEDS TO BE AWARE OF WHEN ADVISING A US/UK COUPLE

I have set down below the key UK IHT rules that the US estate planner needs to be aware of.

- 6.1 UK resident and domiciled individuals are subject to UK taxation on their worldwide income and gains and are subject to IHT on their worldwide assets.
- 6.2 US RNDs who elect for the remittance basis of taxation are subject to UK tax on their UK income and gains and on their foreign income and gains to the extent that they are remitted into the UK.
- 6.3 RNDs who are not deemed domiciled⁴ in the UK are subject to IHT on UK situate assets only⁵. If such individuals become deemed domiciled in the UK, they will be subject to IHT on their worldwide assets.
- 6.4 There is an unlimited spouse/civil partner exemption from IHT subject to the fact that where assets pass from a UK domiciled or deemed domiciled spouse/civil partner to a spouse/civil partner who is not UK domiciled or deemed domiciled, there is only a limited spouse/civil partner exemption of £55,000⁶ available.

- 6.5 Individuals who are registered as civil partners under the Civil Partnership Act 2004 are treated as spouses for UK tax purposes. As I understand it, the US Federal authorities do not recognise civil partnerships and so civil partners are not entitled to the marital deduction for US Federal estate tax purposes. This is so even if the parties entered into a civil partnership in a state in the US that recognises them.
- 6.6 Where it is wished to obtain the spouse/civil partner exemption, assets must be passed to the surviving spouse/civil partner either absolutely or by giving them an "immediate post death interest"⁷ ("IPDI") in the assets.
- 6.7 It is possible for a non-UK domiciled individual to shelter their non-UK assets from IHT by transferring them to an appropriately structured trust, an "excluded property trust"⁸. If this is implemented correctly then the non-UK assets in the trust will remain outside the IHT charge even if the settlor becomes domiciled in the UK⁹.
- 6.8 The UK nil-rate band is £325,000 in 2009/10.
- 6.9 In the UK, it is possible to make an absolute and irrevocable gift, that if structured appropriately, will avoid IHT if the donor survives the gift by seven years¹⁰.

4. Under s267(1)(a) IHTA 1984, an individual is deemed domiciled in the UK if he has been resident in the UK for 17 out of the previous 20 UK tax years. An individual is also deemed domiciled if he has been domiciled under the general law at any time in the previous three years before a relevant event. Deemed domicile applies only for IHT purposes and for the purposes of the pre-owned assets income tax charge.

5. Subject to possible treaty relief in a US/UK context in the case of assets other than:

- real estate; and
- business property of a permanent establishment: Articles 6 and 7 of the estate tax treaty.

6. In a US/UK context, Article 8(3) of the estate tax treaty effectively provides a greater exemption to the extent of 50% of the value of property passing to a non-UK domiciled spouse from a spouse who is a US national (but UK domiciled).

7. Broadly an interest in possession created under a will: s49A IHTA 1984.

8. Under s48(3) IHTA 1984.

9. This is not necessarily the case in relation to interest in possession trusts created before 22 March 2006 in which the settlor or his spouse had an initial life interest: s80 IHTA 1984.

10. A potentially exempt transfer: s3A IHTA1984. After three years the rate of tax is tapered downwards.

7. BENEFITS OF EXCLUDED PROPERTY TRUSTS FOR AMERICANS LIVING IN THE UK

- 7.1 The US rate of estate tax is 45%. The rate of UK inheritance tax ('IHT') is 40%. An excluded property trust is a trust created by an individual who is non-domiciled in the UK consisting of non-UK assets. The benefit of an excluded property trust is that the assets are insulated from IHT even if the settlor/grantor of the trust subsequently becomes domiciled or deemed domiciled in the UK.
- 7.2 The question might be asked, is there any point in creating an excluded property trust for an American to save 40% UK IHT if they going to have to pay 45% US estate tax anyway? There are in fact benefits of creating an excluded property trust because the US estate tax exemption is \$3.5m in 2009 and the UK inheritance tax nil rate band exemption is only £325,000 in 2009/10. Therefore if an American creates an excluded property trust (which can be a grantor trust from a US perspective) it can effectively shelter their assets from UK inheritance tax even if they subsequently become domiciled or deemed domiciled in the UK. In such a case, the net overall US/UK tax saving could be £870,000¹¹. Another advantage of a long term UK resident American having funded an excluded property trust during his lifetime is that it is not necessary to have the added complication of dealing with the US/UK treaty in relation to the assets in the trust fund on death.

8. POTENTIAL IMPACT OF THE UK RELEVANT PROPERTY REGIME ON ILITS AND OTHER TRUSTS

- 8.1 I have included a note on the UK relevant property regime at Appendix 1 to this paper. Broadly the relevant property regime affects trusts created by a UK domiciliary or deemed domiciliary or trusts created by non-UK domiciliaries of UK assets. The regime involves a 20% inheritance tax on funding and tax charges of up to 6% on exits of principal and on the value of trust principal on 10 year anniversaries of the trust's creation. Where the grantor is a non-UK person, the charge only affects the net value of UK situate property in the trust.
- 8.2 I think this point is worth mentioning because I have, on a number of occasions recently, been asked to advise on the UK tax consequences of US/UK couples funding irrevocable life insurance trusts ('ILITs') and the ongoing UK connection of the ILIT long after the couple have ceased all other UK connections came as something of a shock to the clients.
- 8.3 This is best explained by example. Tom is a US citizen, is resident in the UK, and has become deemed domiciled in the UK for inheritance tax purposes. He is married to Jerry (yes a woman!), a UK citizen and domiciliary. Ten years ago his US advisor advised him to fund an ILIT. He and Jerry plan to move to the US permanently in about five years time when their children are finished school in the UK. The ILIT benefits from the UK normal expenditure out of income from IHT¹².
- 8.4 The funding of the trust did not cause a UK inheritance tax charge because it came within the UK expenditure out of income exemption. A note on this exemption is contained in Appendix 2.

11. US\$3.5m is equal to £2.5m using an exchange rate of 1.4. 40% of (£2.5m-£325,000) = £870,000.

12. Under s21 Inheritance Tax Act 1984.

- 8.5 After Tom has ceased UK tax residence for four consecutive UK tax years, he will lose his deemed domiciled status for IHT purposes and have re-started the deemed domicile “clock” and therefore he will have no further UK IHT connections on assets in his free estate unless he has property that is situated in the UK. However, the ILIT is a UK trust as it was funded by a UK deemed domiciled individual. This may not be a significant issue during Tom’s lifetime but if it continues after Tom’s death, at which time it has received the death benefits, it will be within the UK relevant property regime, meaning broadly, a 6% tax charge on exits of principal from the trust and up to 6% tax charge on every ten year anniversary of its creation.
- 8.6 This issue applies not only to ILITs but to all trusts created by UK domiciliaries or deemed domiciliaries.

9. NIGHTMARE ON PLANNING STREET¹³: INTERACTION OF US AND UK TAX RULES USING A CASE STUDY

Brad and Amy¹⁴ – UK family home

- 9.1 Brad is a US citizen and is married to Amy who is a UK citizen and domiciliary. They have two children who are both US and UK citizens. Brad moved to the UK ten years ago and Brad, Amy and the children are resident in the UK. Brad and Amy own a house in South Kensington worth £8m. Brad and Amy contributed equally to the purchase of the UK residence and it is held by them as joint tenants.
- 9.2 If Brad dies, although spouse exemption will be available in the UK, its US equivalent will not be available because Amy is not a US citizen, and so there will be an immediate estate tax liability of 45% of the excess of the value of Brad’s half of the house over \$3.5m.

13. This is in fact the term used in paragraph 20.40 of the Guide to US/UK Private Wealth Planning by Williams, Layman and Nicholson to describe the situation where a UK domiciled decedent dies leaving a US spouse who is non UK domiciled.

14. This case study is based on one used in an article by Patrick Harney: *Divided by a common language*, Tax Adviser July 2008. It can be located at: http://www.forsters.co.uk/cmsfiles/pdf/PH_TA_0708.pdf.

Instead, Brad and Amy should consider severing the joint tenancy so that they can dispose of each half by will and Brad’s will could provide as follows:

- an amount equal to the US estate tax exemption (currently \$3.5m) in an IPDI for Amy with an overriding power of appointment in favour of the children; and
- the residue to a QDOT for Amy, with the QDOT also structured to be an IPDI from a UK perspective.

- 9.3 As Brad is a US citizen, his will, will need to be drafted by a US attorney and reviewed by a UK lawyer.

Estate plan of UK spouse

- 9.4 Because Brad is a non-UK domiciliary, Amy’s estate will only be entitled to the limited spouse exemption from IHT of £55,000. Therefore if she leaves her half on an IPDI for Brad, there will be UK tax at 40%¹⁵ on her death on the excess over £55,000 and further UK tax of 40% on Brad’s death. If she left her half to Brad absolutely, she would avoid UK tax on his death (if he dies non-domiciled) but it would suffer US estate tax. A preferable option is for Amy to leave her half on a discretionary trust for the benefit of Brad and the children which special US language built in so that it does not fall into their estates for US purposes. Admittedly this will trigger 40% tax on Amy’s death but it is not taxed in the UK again except under the relevant property regime and provided the US lawyers have done their work correctly it will also be outside of the US estate tax net. Another advantage of the discretionary trust route is that if Brad has become UK deemed domiciled by the time of Amy’s death, the trustees would have the option to appoint him an IPDI within two years and have it read back into the will under s144 IHTA 1984 so as to obtain the unlimited spouse exemption.

15. In these circumstances, an election could be made for relief under Article 8(4) of the estate tax treaty to reduce the tax by 50%.

APPENDIX 1

THE RELEVANT PROPERTY REGIME

1. Territorial scope

Once it is established that a trust is within the inheritance tax ('IHT') charge either due to the UK domicile of its settlor or the UK situs of its assets, it is necessary to consider whether it is a trust that is taxed under the relevant property regime ('RPR') (a 'relevant property trust').

2. A trust or settlement is a taxable entity in its own right and as such may be liable for IHT. A major change was introduced by the Finance Act 2006, which effectively ended the distinction between types of trust for IHT purposes, so any lifetime trust (other than a disabled person's trust) created after 22 March 2006 is taxed under the RPR which previously applied only to discretionary trusts.

3. It is easier to set out the kind of trusts that are not relevant property trusts as all other trusts are now relevant property trusts. The trusts set down below are not relevant property trusts and are taxed under the old rules i.e. the rules applying to all interest in possession trusts before 22 March 2006 whereby the life tenant is treated as owning the underlying assets for IHT purposes.

4. Trusts that are not relevant property trusts:

- Life interest trusts in existence on 22 March 2006 which continue to have the same life tenant;
- New life interests carved out of pre-22 March 2006 life interests and created before 6 October 2008 and satisfying the conditions of s49B IHTA 1984 (known as "transitional serial interests" ("TSIs"));
- Immediate post death interests; broadly interest in possession trusts created under a will; and
- Disabled person's trusts.

5. Any trust that does not come within the categories outlined at paragraph 4 is a relevant property trust. So, for example, any new trust created during a person's lifetime that is not a disabled person's trust is a relevant property trust.

6. Basis of charge for property held upon relevant property trusts

6.1 IHT is charged on relevant property, that is, settled property in a settlement (trust) in which there is no qualifying interest in possession (a qualifying interest in possession is one described at paragraph 4 above).

6.2 Put simply, an interest in possession ('IIP') means that the trustees have to pay the trust income to a beneficiary, or allow the beneficiary to have use of trust assets. The old rules continue to apply to all IIPs in existence at 22 March 2006 and to TSIs created before 6 October 2008, therefore on death the value of the trust assets is aggregated with the beneficiary's estate and subject to IHT. This is because for IHT purposes the beneficiary is treated as the absolute owner of his interest in the trust.

6.3 The IHT rules under the RPR are briefly summarised below:

- Creation of a settlement

On the creation of a settlement or a transfer into an existing settlement during the lifetime of the settlor there is an immediate IHT charge at a rate of 20% on the value of assets transferred into the settlement over the IHT nil rate threshold (£325,000 in 2009/10).

Relief is available for business property and agricultural property and for normal expenditure out of income where the relevant conditions are met. Should the transferor die within seven years of the transfer into trust, the tax rate is increased to the full 40%.

- Periodic and distribution (exit) charges

Trusts within the RPR are subject to periodic charges on every tenth anniversary of the creation of the settlement at a maximum rate of 6% of the value of the trust assets over the nil rate threshold. There is an exit charge at a maximum of 6% on the value of the capital leaving the trust over the nil-rate threshold. There is no exit charge if property leaves the settlement within three months after the creation of the settlement or within three months of a ten year anniversary charge.

APPENDIX 2

NORMAL EXPENDITURE OUT OF INCOME EXEMPTION FROM UK INHERITANCE TAX

The statutory basis for the NEOI exemption is found in section 21(1) IHTA 1984, which provides that:

“A transfer of value is an exempt transfer if, or to the extent that, it is shown:

- (a) that it was made as part of the normal expenditure of the transferor;*
- (b) that (taking one year with another) it was made out of his income; and*
- (c) after allowing for all transfers of value forming part of his normal expenditure, the transferor is left with sufficient income to maintain his usual standard of living.”*

Each of the three conditions must be satisfied.

There is no upper limit to the amount that can be claimed under this exemption, and it is therefore particularly suitable for use where an individual has a regular surplus of annual income. Transfers of this excess income can be made to trusts within the relevant property regime without triggering entry charges (at 20% over the inheritance tax nil-rate band), or to individuals without the risk of the transfers being brought into account for the purposes of calculating the inheritance tax payable on the transferor's subsequent death within seven years of the transfer.

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