Tolley's Taxwise 2014-15

Part II

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Inheritance Tax
Taxation of Trusts
Taxation of Estates

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About this book

For over 30 years Tolley's Taxwise II has provided practitioners with a practical means of keeping up to date with changing legislation relating to inheritance tax and trusts. This is achieved by way of worked examples, which have been updated annually and which, in this edition, illustrate the major changes introduced by Finance Act 2014.

The publication is useful as a manual for staff, also acting as a training aid, as well as giving guidance as to the layout of computations. The examples are supplemented with explanatory notes explaining the law and practice relating to the issue illustrated.

The Taxwise publications are invaluable for students enabling them to apply their theoretical knowledge to practical examples of the types used by examiners in professional examinations.

COVERAGE

A selection of examples on inheritance tax, taxation of trusts and taxation of estates, based on the legislation current for 2014/15, complete with annotated solutions.

The examples are preceded by a summary on page (xv) of the relevant provisions of Finance Act 2014, which received Royal Assent on 17 July 2014.

The book is not an exhaustive work of reference but it shows the treatment of the points that are most likely to be encountered.

The contents list starting on page (v) shows the broad coverage of each example. In addition, there is a general index at the back of the book to assist in the location of specific points.

All statutory references in the inheritance tax sections of the book are to the Inheritance Tax Act 1984 unless otherwise stated.

References to ITTOIA 2005 are to the Income Tax (Trading and Other Income) Act 2005.

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COMPANION PUBLICATION

Tolley's Taxwise I 2014/15 (covering Income Tax and National Insurance, Corporation Tax, Capital Gains Tax, Stamp Duty and VAT).

Abbreviations

AA 1870	Apportionment Act 1870
A & M trusts	Accumulation and maintenance trusts
art	Article
CA	Court of Appeal
CAA	Capital Allowances Act
c/f	compare
CFC	Controlled Foreign Company
ChD	Chancery Division
CIoT	Chartered Institute of Taxation
CGT	Capital Gains Tax
CGTA 1979	Capital Gains Tax Act 1979
CIR	Commissioners of Inland Revenue ('the Board')
CRCA	Commissioners for Revenue and Customs Act
CT	Corporation Tax
CTT	Capital Transfer Tax
CTTA 1984	Capital Transfer Act 1984
DoTAS	Disclosure of tax avoidance schemes
EC	European Communities
ECHR	European Court of Human Rights
ECJ	European Court of Justice
EEC	European Economic Community
EU	European Union
Ex D	Exchequer Division
FA	Finance Act
F(No 2)A	Finance No 2 Act
FII	Franked Investment Income
FY	Financial Year
HC(I)	High Court (Ireland)
HL	House of Lords
HMRC	Her Majesty's Revenue and Customs
ICTA	Income and Corporation Taxes Act 1988
IHT	Inheritance tax
IHTA 1984	Inheritance Tax Act 1984
IIP	Interest in possession
IPDI	Immediate post-death interest

ITA	Income Tax Act 2007
ITEPA 2003	Income Tax (Earnings and Pensions) Act 2003
ITTOIA 2005	Income Tax (Trading and Other Income) Act 2005
NIC	National insurance contribution
NPDI	Net pre-death income
NSB	National Savings Bank
pa	per annum
POA	Payments on account
POCA 2002	Proceeds of Crime Act 2002
RCC	Revenue and Customs Commissioners
s	Section
SA	Self-assessment
Sch	Schedule
SI	Statutory Instrument
SSCBA 1992	Social Security Contributions and Benefits Act 1992
SSI	Scottish Statutory Instrument
SP	Revenue Statement of Practice
Sp C	Special Commissioners
STC	Simon's Tax Cases
STC (SCD)	Simon's Tax Cases (Special Commissioners)
STEP	Society of Trusts and Estate Practitioners
TCGA 1992	Taxation of Chargeable Gains Act 1992
TMA 1970	Taxes Management Act 1970
TCIA 2013	Trusts (Capital and Income) Act 2013
TSI	Transitional serial interest
UKFTT	UK First-tier Tribunal
UKUT	UK Upper Tribunal
VAT	Value Added Tax
VATA 1994	Value Added Tax Act 1994
VE	Value of estate
VQTI	Vulnerable person's liability (see also Finance Act 2005 s 28)

Tax Rates and Thresholds

CAPITAL TRANSFER TAX – RATES FROM 13 MARCH 1975 TO 14 MARCH 1988

Nil-rate threshold	*From*	*To*
£15,000	13.03.1975	26.10.1977
£25,000	27.10.1977	25.03.1980
£50,000	26.03.1980	08.03.1982
£55,000	09.03.1982	14.03.1983
£60,000	15.03.1983	12.03.1984
£64,000	13.03.1984	05.04.1985
£67,000	06.04.1985	17.03.1986
£71,000	18.03.1986	16.03.1987
£90,000	17.03.1987	14.03.1988

INHERITANCE TAX – RATES FROM 15 MARCH 1988

Since 15 March 1988 there has been a single rate of inheritance tax of 40% (halved for some lifetime transfers), applicable where the gross cumulative chargeable transfers exceed a stipulated threshold:

Threshold	*Fixed by*	*Applicable to following transfers*
110,000	Finance Act 1988 s 136	Between 15 March 1988 and 5 April 1989
118,000	SI 1989/468	Between 6 April 1989 and 5 April 1990
128,000	SI 1990/680	Between 6 April 1990 and 5 April 1991
140,000	SI 1991/735	Between 6 April 1991 and 9 March 1992
150,000	F (No 2) A 1992 s 72, FA 1993 s 196, and FA 1994 s 246	Between 10 March 1992 and 5 April 1995
154,000	SI 1994/3011	Between 6 April 1995 and 5 April 1996
200,000	Finance Act 1996 s 183	Between 6 April 1996 and 5 April 1997
215,000	Finance Act 1997 s 93	Between 6 April 1997 and 5 April 1998
223,000	SI 1998/756	Between 6 April 1998 and 5 April 1999
231,000	SI 1999/596	Between 6 April 1999 and 5 April 2000
234,000	SI 2000/803	Between 6 April 2000 and 5 April 2001
242,000	SI 2001/639	Between 6 April 2001 and 5 April 2002
250,000	Finance Act 2002 s 118	Between 6 April 2002 and 5 April 2003
255,000	SI 2003/841	Between 6 April 2003 and 5 April 2004
263,000	SI 2004/771	Between 6 April 2004 and 5 April 2005
275,000	Finance Act 2005 s 98	Between 6 April 2005 and 5 April 2006
285,000	Finance Act 2005 s 98	Between 6 April 2006 and 5 April 2007
300,000	Finance Act 2005 s 98	Between 6 April 2007 and 5 April 2008
312,000	Finance Act 2006 s 155	Between 6 April 2008 and 5 April 2009
325,000	Finance Act 2006 s 155	Between 6 April 2009 and 5 April 2010
325,000	Finance Act 2010 s 8	Between 6 April 2010 and 5 April 2015
325,000	Finance Act 2014 Sch 25	Between 6 April 2015 and 5 April 2018

INCOME TAX RATES FOR INDIVIDUALS

Earnings, pensions, taxable state benefits, self-employed profits and rental profits up to the basic rate limit of £31,865 (2014/15) are taxed first at the rate of 20% (basic rate).

Savings income (being, broadly speaking, bank and building society interest but defined further in ITA 2007 s 18) is regarded as the part of taxable income which is taxed next. There is a 10% starting rate for savings income only.

The starting rate limit for 2014/15 is £2,880.

If taxable non-savings income (ie earnings, pensions etc as mentioned above) is more than this limit, then the 10% savings rate will not apply and savings income will be taxed in full at the basic rate of 20%. However, if an individual has total taxable non-dividend income (including savings income) of between £10,000 and £12,880, the 10% rate will apply to all of his savings income. For people born before 6 April 1948, who are receiving the higher personal allowance or for those individuals claiming blind person's allowance these limits will be increased. If the individual's total taxable non-dividend income (including savings income) exceeds £12,280 and his non-savings income falls within the above range, his non-savings income up to £12,280 is taxed at 10% and the balance is charged at the basic rate of 20%.

Taxable non-dividend income (whether or not it is savings income) over £31,865 will be taxed at the 40% higher rate up to the higher rate limit of £150,000. Non-dividend income over £150,000 is taxed at 45%. Dividends and other distributions (including those from share buy-backs) form the final part of taxable income.

They are regarded as the top slice of an individual's taxable income and are taxed at the dividend ordinary rate of 10% to the extent that they fall within the basic rate limit of £31,865, at the dividend upper rate of 32.5% to the extent that they fall between the basic rate limit and the higher rate limit of £150,000, and at the dividend additional rate of 37.5% to the extent they exceed the higher rate limit. Dividends etc carry tax non-refundable credits at the 10% rate which are used to reduce the individual's income tax liability.

An individual's personal allowance is withdrawn (gradually) where total taxable income is in excess of £100,000.

For every £2 of income above the £100,000 threshold, £1 of the personal allowance will be removed until the personal allowance is extinguished at an income level of £120,000 (in 2014/15). For income between £100,000 and £120,000 the effective marginal income tax rate is thus 60%.

INCOME TAX RATES FOR TRUSTS AND ESTATES

Special trust rates

The 'trust rate' (ITA 2007 s 9) applies to income of discretionary and accumulation trusts and to certain deemed income of other trusts. In 2014/15 the rate is 40% (ITA 2007 s 9(1)).

The 'dividend trust rate' applies to company dividends and other distributions (including share buy-backs) of discretionary and accumulation trusts. In addition it applies to share buy-back distributions received by all trusts.

In 2014/15 the rate is 37.5% (ITA 2007 s 9(2)).

These special trust rates do not apply to the first £1,000 of trust income; instead that will be charged at the basic rate or the dividend ordinary rate as the case may be.

Trust income not liable at special rates and personal representatives

Trustees of other trusts and personal representatives of deceased estates are charged at the dividend rate of 10% on dividend income (except, as already stated, in the case of trustees, in relation to a distribution on a share buy-back), and the basic rate of 20% on savings income and non-savings income.

Trusts with vulnerable beneficiaries

Trusts with vulnerable beneficiaries are able to elect irrevocably for the income and gains of the trust to be taxed as if the income belonged to the vulnerable beneficiary. See **Example 67**.

CAPITAL GAINS TAX RATES

Gains qualifying for entrepreneurs' relief will be charged at a rate of 10%, and the lifetime limit of such gains is raised to £10 million from 6 April 2011 (FA 2011 s 9). This relief is discussed in more detail in **Examples 23** and **60**.

Apart from the entrepreneurs' relief rate, the rate of capital gains tax for an **individual** is, subject to what is said below, 18% (TCGA 1992 s 4(1), (2)) and that is applied to his net chargeable gains for a year (ie after the annual exemption of £11,000 in 2014/15). However, if income tax is charged at the higher rate or the dividend upper rate in respect of any part of the taxable income (after personal allowances) of an individual for a tax year, the rate of capital gains tax in respect of the gains accruing to him in the year is 28% (TCGA 1992 s 4(4)). If no income tax is chargeable at the higher rate or the dividend upper rate in respect of an individual's income for a tax year, but the amount on which the individual is chargeable to CGT exceeds the unused part of his basic rate band, the rate of CGT on the excess is 28% (TCGA 1992 s 4(5)). In applying this rule, gains charged at the Entrepreneurs' relief rate are treated as the lowest part of the amount on which the individual is charged to CGT (TCGA 1992 s 4(6)).

Certain CGT reliefs allow a gain arising on a disposal of an asset to be deferred until sometime after the disposal. For instance, a gain can be reinvested in shares under the Enterprise Investment Scheme (EIS) and, subject to conditions, can be deferred until the EIS shares are disposed of. The CGT rates on a gain deferred in this way will be those in force at the time the deferral ends and the gain becomes liable to tax.

Personal representatives are entitled to the annual exemption, currently £11,000 for the tax year of death and the next two tax years. For 2014/15, gains not covered by the exemption are taxed at 28% (TCGA 1992 s 4(3)). They are not entitled to Entrepreneurs' relief.

For **trustees**, the CGT rate in 2014/15 is 28% except in certain cases where entrepreneurs' relief applies when the rate is 10%. Trustees are entitled to an annual exemption (AE) of £5,500 in 2014/15, divided equally between trusts created by the same settlor after 6 June 1978, subject to a minimum AE in 2014/15 of £1,100 for each trust.

SUMMARY OF PROVISIONS OF FINANCE ACT 2014 RELATING TO INHERITANCE TAX AND THE TAXATION OF TRUSTS AND ESTATES

Finance Act 2014 reference		*Example*
	Tax rates and allowances	
s 1	Income tax rates unchanged for 2014/15; basic-rate limit set at £31,865. Standard personal allowance set at £10,000.	*64*
s 4	Indexation of bands and limits (where applied) to be by reference to the Consumer Prices Index rather than the Retail Prices Index as from 2015–16.	
s 8	The annual exempt amount for CGT is set at £11,000 for 2014–15.	*23*
s 9	The annual exempt amount for CGT is set at £11,100 for 2015–16.	
s 58	For disposals of a private residence made after 5 April 2014, it is only the last 18 months (and not 36 months, as previously) of the period of ownership during which the property need not be the individual's only or main residence for the CGT exemption not to be lost. The 36-month period is retained, subject to conditions, where the individual making the disposal has a spouse or civil partner who is disabled or a long-term resident in a care home, or is himself disabled or a long-term resident in a care home.	
s 60	For deaths occurring after 4 December 2013, the CGT uplift on death applying to property held on trust for the benefit of a vulnerable beneficiary is extended to apply to disabled trusts where the beneficiary has no absolute entitlement to the income of the trust.	*41*
s 117 & Sch 25	Nil rate band for IHT frozen until April 2018 by the disapplication of statutory indexation.	*2*
s 117 & Sch 25	Disallowance of liabilities in the estate which finance new excluded assets, being foreign currency bank accounts which would not be included in the value of estate at death where the position arises from tax avoidance motives.	*4*
s 117 & Sch 25	Inclusion of rolled up income in the value of property subject to the ten year anniversary charge where that income arose at least five years before the charge is calculated.	
s 117 & Sch 25	Amendment to the due date for filing returns and payment of tax on the ten year anniversary charge.	*69*

Inheritance Tax — Personal and Estates — General

Contents

Question

(a) Outline the basic principles of inheritance tax.

(b) 'Disposition', 'transfer of value', 'chargeable transfer', 'potentially exempt transfer' and 'relevant property' are primary terms which need to be considered when determining whether an inheritance tax liability arises on a transaction. Explain the meaning of each term, demonstrating how the terms are linked together.

(c) Explain the rates at which inheritance tax is charged, the term 'nil-rate band' and state when a transfer of the nil-rate band is available.

(d) Explain how inheritance tax can become payable at death in respect of transfers of value already made in lifetime.

(e) Outline the exemptions from inheritance tax.

(f) Explain the 'grossing up' of a lifetime transfer.

Answer

(a) Basic principles of inheritance tax

Introduction of inheritance tax

Inheritance tax (IHT) is a continuation of capital transfer tax which was originally introduced by FA 1975 and had effect from 27 March 1974 for lifetime gifts, and from 13 March 1975 for transfers on death. The tax (and the legislation) was renamed as IHT from 18 March 1986 when the approach to lifetime gifts was radically overhauled.

Scope of inheritance tax

The tax applies to individuals and trusts. In the case of an individual, IHT must be considered when he enters into transactions during his lifetime that result in a fall in the value of his overall wealth (ie his estate) and when he dies. Husbands and wives and civil partners are separate chargeable persons for IHT, each also being able to take advantage of any available reliefs and exemptions.

In order to be within the charge to IHT an individual must be linked with the UK either by being domiciled in the UK or by owning property that is located in the UK. Consequently, if an individual is domiciled in the UK, he is liable to IHT on all his assets no matter where in the world they are located. If he is not domiciled in the UK, then he is liable to IHT only on those assets that are located in the UK. For more information on these matters, including situations where a person may be treated for IHT as domiciled in the UK (even though he may not domiciled in any part of it under the general law), see **Example 4(a)**.

Lifetime transfers

Lifetime transfers that result in a fall in the value of an individual's estate are called transfers of value and are prima facie within the charge to IHT. Transfers of value occur most obviously when an individual makes gifts of his property. Gifts (and other transfers of value) may be outside the scope of IHT or completely exempt from IHT (see **part (d)**). If they are not exempt, they are classified either as *chargeable lifetime transfers* or *potentially exempt transfers* (see **part (b)**).

Position on death

Inheritance tax also applies when an individual dies. On this occasion two matters have to be considered. First, the transfers that the individual made during his lifetime in the seven years before his death are reconsidered and their liability to IHT is re-assessed. Secondly, all the property that he owns at the time of his death (ie his deceased estate) is charged to tax. The individual is deemed to make a transfer of his entire estate when he dies. In some cases, the deceased estate is regarded as containing property not in the direct ownership of the deceased, such as that owned by trustees in which the deceased has an estate interest in possession (see **Example 41**) and that owned by a donee in circumstances where the donor still enjoys the use of the property so that he is said to have a reservation of benefit in it (see **Example 30**).

Where the donor has avoided a pre-owned asset income tax charge by making an election under FA 2004 Sch 15 para 21 or para 22 then the asset concerned is treated for IHT as a gift with reservation and is similarly treated as forming part of his estate when he dies (see **Example 30**).

Inheritance tax – the occasions of charge

In general terms, it follows from the above outline that a charge to IHT may arise on three separate occasions:

- When an individual makes a transfer of his property during his lifetime

- On his death when his lifetime gifts are reconsidered
- On his death when the property that he owns is taxed.

These occasions are considered in the order set out above. This is because the tax arising on a later transfer (including the deemed transfer of the deceased estate at death), depends on the timing and size of earlier transfers.

For example, where inheritance tax is calculated on a chargeable lifetime transfer, it is necessary to take into account chargeable transfers that have been made in the previous seven years. Tax is calculated on the current transfer by reference to the total amount of chargeable transfers made in that period. If the aggregate of the values of the cumulated transfers and the present chargeable transfer exceeds the threshold at which tax becomes payable, then the current transfer is charged at the rates applicable at the time it is made. See **part (c)** below for more details about the rates of IHT.

Similarly, when an individual dies, the value of his chargeable estate is added to the aggregate values of the chargeable transfers made in the seven years preceding his death to determine the tax liability arising in relation to his estate. Tax is charged to the extent that the combined values exceed the nil-rate threshold in force at the time of his death. Again see **part (c)** below for a definition of the term 'nil-rate threshold'.

In addition, transfers made in the seven-year period before death that were potentially exempt now become chargeable because of the death. Transfers made in the same period before death that were chargeable when made, suffer an additional charge to tax. In re-charging both types of transfer, chargeable transfers made within the period of seven years before each particular transfer are taken into account even though the rates of tax used are those applicable at the date of death (if those rates produce a lower charge than the rates in force at the date of the transfer). Tax will only be payable to the extent that the aggregate value of the transfers, less any unused annual exemption at the time of the gift (see **explanatory note 6**), exceed the nil-rate band in force at the date of death; and a taper relief is available in respect of tax on transfers made at least three years before death as indicated in **part (c) below**.

If a donor survives a *potentially exempt transfer* by seven years, it will not attract IHT unless the donor retains an interest in or benefits from the gifted property, in which case the seven year survivorship period only starts to run from the time the interest or benefit ceases (see **Example 31**).

Calculation of tax

Because the IHT nil-rate threshold is increased annually (unless Parliament decides otherwise – which it has for years up to and including 2017/18 (FA 2013 Sch 21 para 2) and because tax rates may also change, it should be borne in mind that the correct starting point for calculating tax on any occasion of charge is the cumulative chargeable transfers within the previous seven years. Those transfers are deemed to use up the nil-rate band before the current transfer. So the tax on the current transfer should be calculated using a cumulative tax figure for the earlier transfers based on the *current* scale of rates (or, if lower, the scale of rates at death, where tax or additional tax arises as a result of the donor's death within seven years). That cumulative tax figure for computation purposes will often not equate to the tax that has actually been paid, but it is the simplest way to make the tax calculation (see the Example in **part (c)**).

Trusts

Where property is held in trust, the IHT treatment depends on the type of trust. The detailed provisions relating to trusts are dealt with in **Examples 39** to **57**.

(i) If the settlement has an *interest in possession* (IIP) (see **Example 41**, broadly where one or more persons are entitled to the income), and it is an estate IIP (again see **Example 41** and **Example 59 footnote (2)** in which this term is explained), the property in the settlement is deemed to belong to the person who is entitled to that interest and any liability will arise when that person's interest in the property comes to an end (eg where he makes a sale or gift of his interest, or his interest ceases by reason of a death, marriage, appointment or other reason). Like any other transfer in lifetime, however, the cessation of the life interest may be potentially exempt. This will apply where the trust property is transferred to an individual, or to a disabled trust. The transfer will only become a chargeable transfer if the life tenant who has given up his interest dies within the next seven years, the tax being computed by taking into account transfers within the seven years before the now chargeable transfer and calculating tax using the rates applicable at the date of death (see **Example 3 explanatory note 3**).