BPR-qualifying assets and the ten-year periodic charge for discretionary trusts

The Finance Act 2006 brought about sweeping changes to the rules relating to trusts, including the introduction of the ten-year periodic charge. However, as Jessica Franks explains, investments that qualify for Business Property Relief could effectively complement trust arrangements and mitigate potential inheritance tax charges at several stages.

A discretionary trust can be an effective way to pass assets down from one generation to the next with a degree of flexibility and control. They also used to be highly advantageous from an inheritance tax planning perspective. However, this all changed in 2006, after the Government took steps to ensure discretionary trusts could no longer escape inheritance tax indefinitely.

The move towards relevant property trusts

After 22 March 2006, the majority of discretionary trusts were classed as "relevant property trusts" for inheritance tax purposes. The new rules introduced four stages at which an inheritance tax charge could potentially arise in respect of a relevant property trust:

1. **The entry charge or CLT:** a 20% upfront charge known as the 'chargeable lifetime transfer' (CLT) when assets are settled in excess of the nil-rate band.
2. **Charge upon death of the settlor:** if the settlor dies within the first seven years of settling assets into trust, the estate would be liable for a full 40% inheritance tax charge, minus taper relief and any CLT already paid.
3. **The periodic charge:** broadly speaking, this is a 6% charge arising on each ten-year anniversary of the creation of the trust and applied to amounts over the nil-rate band. If more than one trust has been set up, each will have its own nil-rate band for this purpose, provided the trusts were set up on different days and the settlement of assets has also been made on different days.
4. **The exit charge:** a 6% charge, calculated across the ten-year period on a pro rata basis, and applied when capital is distributed by the trust, to the extent where the trust capital exceeds the nil-rate band.

Charges upon the death of the settlor

It is worth noting that settlements made into a discretionary trust use up the settlor's nil-rate band in priority, such that if they die within seven years of settling assets into trust, the amount of nil-rate band available to set against the settlor's estate will be reduced. It is also necessary to look back seven years to see whether any other settlements have been made in that period. If they have, the nil-rate band available for the current settlement may be either reduced or completely eliminated.

The periodic charge

Discretionary trusts that were set up prior to the relevant property trust regime will have already paid their first periodic charge. However, in light of the large number of trusts that were set up in 2006 following the changes to the legislation, many professionals will have started thinking about the impact of the periodic charge on relevant cases. In addition, where a trust is approaching its ten-year anniversary, trustees will have to calculate whether an inheritance tax charge is due and complete a tax return.

Exit charges

Where trustees are looking to distribute capital out of the trust, there could be inheritance tax to pay. The rate of inheritance tax is based on the rate paid on the previous periodic charge (if applicable). This rate will be calculated pro rata across the current ten-year period from the date of the last ten-year charge to the date of the capital distribution. This means that, for example, if trustees choose to exit the investment five years short of its next ten-year anniversary, the rate applicable will be half of that which was charged at the last ten-year point.

All of these charges really start to add up

Factor in the CLT upon entry, the ten-year periodic charge and exit charges, and it appears many discretionary trusts could be facing significant charges to inheritance tax which, when combined, could have the effect of substantially reducing the value of the trust to the beneficiaries. Some clients may even feel discouraged from settling assets into trust precisely because of the prohibitive costs involved.

Trustees and settlors who are interested in investments that qualify for Business Property Relief (BPR) could mitigate some or all of the inheritance tax charges applicable to the trust. Shares that qualify for BPR should become free from inheritance tax as long as they have been held for at least two years and are still held at the time of death.

BPR has come a long way since it was first introduced as part of the 1976 Finance Act. Its main aim then was to ensure that after the death of its owner, a family-owned business could survive as a trading entity without having to be sold or broken up to pay an inheritance tax liability. Over time, successive governments have recognised the value of a tax relief that encourages people to invest in trading businesses, regardless of whether they run the business themselves.

BPR is recognised today as an incentive to invest in unlisted trading companies or those listed on the Alternative Investment Market (AIM). But BPR-qualifying investments should be considered for their investment characteristics as well as the tax relief they can deliver. In addition, it is important to recognise that not every unlisted or AIM-listed company will qualify for BPR. Therefore, it usually pays to delegate stock selection and portfolio management to investment specialists who can help make sure that the companies have a strong investment case, as well as being eligible for BPR.

How BPR can help reduce trust charges

BPR-qualifying investments can help settlors to reduce inheritance tax charges at each of the four stages where a charge could arise. Here's how:

1. **No entry charge or CLT:** A client who owns BPR-qualifying assets for at least two years, and chooses to settle these into trust, can benefit from facing no CLT, no matter how significant the value of the qualifying property settled.

2. **No charge upon death:** If the trust continues to hold investments that qualify for BPR, there will be no further inheritance tax charge, even if the settlor dies within seven years from the date the assets were settled into trust.

3. **No periodic charge to pay:** a trust settled wholly with BPR-qualifying investments – which continues to hold them at year ten – will have no periodic charge to pay. Even trusts that were settled with non-qualifying assets, or which sold down BPR-qualifying investments at an earlier date, can mitigate the periodic charge. However, this would only apply if the trust comprises 100% BPR-qualifying investments at the ten-year anniversary date, and has held them for more than two years at that time.

4. **No exit charge:** as the rate applicable to capital distributions is based on the last periodic charge (if past the ten-year mark), provided the trust held BPR-qualifying investments at the ten-year mark, and therefore faced an inheritance tax charge of zero, no exit charges will be payable if capital is distributed in the next ten years.

If a BPR-qualifying investment is settled into trust but is later sold by the trustees, a charge to inheritance tax can arise if the settlor dies within seven years of making the settlement. However, if trustees find themselves in this situation, they may choose to reinvest all of the proceeds back into BPR-qualifying assets. If they are able to do so within three years of having made the disposal, full inheritance tax relief may be restored on the settlement – a saving of up to 40%.

Important risks to remember

The value of a BPR-qualifying investment, and any income from it, can fall as well as rise. Investors may not get back the full amount they invest. Investing in unlisted companies, and companies listed on AIM, carries greater risk because their day-to-day value can fall or rise more significantly than those listed on the main market of the London Stock Exchange.

Tax treatment will depend on each investor's individual circumstances and can change in the future. The availability of tax reliefs will depend on portfolio companies maintaining their BPR-qualifying status.

The importance of long-term estate planning

With an increasing number of discretionary trusts reaching the ten-year mark, it makes sense for estate planners to be thinking about the rewards that could be available if BPR-qualifying investments are chosen. For those comfortable with the risks, BPR-qualifying investments also present an opportunity for settlors who are thinking about settling significant amounts in to trust. Provided the trust acquires BPR-qualifying assets at least two years in advance of the ten-year trust anniversary, there will be no periodic charge to pay.

Since 2006, anyone with experience of settling assets into trust will recognise that the introduction of additional charges has made estate planning through trusts considerably more cost-prohibitive. By placing their BPR-qualifying investments into the trust, settlors can take advantage of a significant investment opportunity while also having a greater element of control over how much their beneficiaries are likely to receive.

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A working example: meet Louise

Let's go back to the year 2008. Louise wants to provide for her children and grandchildren after she dies. One of her biggest concerns is that the marriage of one of her children could end in divorce. Louise wants to make sure that her grandchildren will benefit from her wealth, rather than her assets being lost through any divorce proceedings.

Louise talks to her financial adviser

Her adviser discusses settling her existing share portfolio worth £600,000 into a discretionary trust for her children and grandchildren. He explains that as she has not previously made any gifts or settled any trusts, she will be able to settle £325,000 (her nil-rate band) into the trust with no charge. The additional £275,000 would be subject to an immediate CLT of 20%, which would reduce the amount in the trust by £55,000.

After talking through the investment opportunity, and after explaining the risks and benefits of making an investment in a BPR-qualifying portfolio, Louise's adviser recommends selling her shares. The proceeds can then be invested into a discretionary managed service featuring AIM-listed companies that are expected to qualify for BPR. After two years, Louise can consider settling the shares into a discretionary trust and no CLT will be payable. The trustees can feel confident that if the shares are held by the trust for ten years, no periodic charge will be due. Also, when the time comes for capital to be distributed by the trust, as the trust assets are entirely BPR-qualifying, there should be no 6% exit charge.

What if Louise dies before the discretionary trust reaches seven years?

If non-BPR-qualifying assets had been settled above the nil-rate band, then a further charge to inheritance tax would arise. Louise's nil-rate band would also be set in priority against the trust, resulting in her death estate being taxable in full. However, if Louise's discretionary trust continues to hold investments that qualify for BPR, there will be no further inheritance tax charge – even if Louise dies within the first seven years from the date that assets were settled into trust.

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