CHAPTER 6

EXIT CHARGES ON DISCRETIONARY TRUSTS

6.1 General principles

In a discretionary trust arrangement, trustees have **absolute discretion as to how to distribute the income and capital** of the trust, and may have a **power to accumulate income** within the trust. If trustees have a power to accumulate income, no individual beneficiary has an entitlement to income so no interest in possession exists.

In certain circumstances if a beneficiary has an interest in possession in a trust, the trust assets will be **treated as part of the beneficiary's estate**. This will **not** be the case if an individual is a beneficiary of a **discretionary** trust. If a beneficiary of a **discretionary** trust dies, **no part** of the discretionary trust falls within the death estate. We will deal with interest in possession trusts in a later session.

Assets held in a discretionary trust will form part of the deceased's death estate only if the deceased was **both the settlor and a beneficiary** of the trust. If an individual sets up a discretionary trust from which he or she can benefit, this is a **gift with reservation** of benefit. In this situation, the assets of the trust form part of the death estate for IHT purposes. This is an exception to the general rule and assets in a discretionary trust are not usually charged to IHT in the hands of a beneficiary.

6.2 Inheritance tax charges

Because, under normal circumstances, HMRC cannot levy an IHT charge on a beneficiary of a discretionary trust, any such **charges will arise on the trustees** instead. The two inheritance tax charges we shall look at over the next couple of chapters are the "**exit charge**" and the "**principal charge**".

IHTA 1984, s.64
IHTA 1984, s.65

In the next chapter we shall look at the principal charge (otherwise known as the "10 year" charge). On each **tenth anniversary from the creation** of the trust, HMRC will levy a "one off" inheritance tax charge on the trustees. This is regarded by most trustees as a penalty for having such wide discretionary powers. The principal charge is a **percentage of the value of the trust** on each 10 year anniversary. Principal charges will arise on the 10th, 20th, 30th birthday etc of the trust.

As we shall see in the next session, only **30%** of the value of the trust is charged to inheritance tax, this equating to a full IHT charge every 33 years.

One way to avoid a principal charge is for the trustees to distribute all of the trust assets to one or more beneficiaries prior to the 10th anniversary. However, when **trustees make a capital distribution to a beneficiary** such that the value of the trust property goes down, an **"exit charge" will arise**. The exit charge is a percentage of the value of the property leaving the trust.

In this chapter we shall concentrate on how to calculate IHT on capital distributions from discretionary trusts. The rules with regard to exit and principal charges changed with effect from 26 March 1974 when capital transfer tax was introduced. We will only look at the rules for trusts set up since 1974.

6.3 Definition of terms

Assume on 1 July 2011, a donor (Mr Settlor) set up a discretionary trust for his family. The property settled was £1 million in cash. On the same day, i.e. 1 July 2011, Mr Settlor also set up an interest in possession trust for the son with £500,000 in cash.

It is important to establish the **date of commencement** for IHT purposes, as this date will determine the date for future principal charges. Here the date of commencement is 1 July 2011. IHTA 1984, s.60

Exit and principal charges are only levied on "**relevant property**". Relevant property is property in which **no qualifying interest in possession subsists**. We will look at qualifying interests in possession in a later chapter. IHTA 1984, s.58

Broadly speaking, a qualifying interest in possession is one which arose before 22nd March 2006 (with some exceptions). Therefore post 2006 interest in possession trusts can also be "relevant property trusts" and will fall within the exit and principal charge regime.

For the time being we shall assume that "**relevant property" means property held in a discretionary trust**.
If two trusts are set up on the same day by the same settlor, those trusts are called "**related settlements**". In this example, the settlor set up a discretionary trust and an interest in possession trust on 1 July 2011, so he has set up 2 related trusts. IHTA 1984, s.62

A "related trust" does not include a charitable trust set up on the same day by the same settlor. It also does not include a settlement in which the settlor's spouse has an immediate post-death interest (see chapter 12). IHTA 1984, s.80

The effect of a related trust is to increase the IHT payable on an exit or principal charge. Therefore a settlor should avoid setting up 2 trusts on the same day wherever possible. In practice you are most likely to come across related trusts where 2 different trusts are set up by a testator in his will.

6.4 Exit charges

An exit charge will arise when a **property in a trust ceases to be relevant property**. This will most commonly apply when a discretionary trust distributes cash or capital assets to a beneficiary. As there has been a reduction in the value of relevant property within the trust, an exit charge will arise. IHTA 1984, s.65(1)

There are certain instances where there is no exit charge for IHT purposes.

No exit charge will be levied where income is distributed by the trustees to a beneficiary. If a beneficiary receives a distribution of income, the beneficiary will suffer **income tax rather than inheritance tax**. IHTA 1984, s.65(5)(b)

If the value of relevant property is reduced because certain **costs or expenses are met by the trustees**, this does not give rise to an exit charge. IHTA 1984, s.65(5)9a)

No exit charge is levied on a transfer of **excluded property**. If you remember back to the IHT chapter on domicile, if a non UK domiciled individual sets up a trust, the trust is also treated as not UK domiciled – ie, the domicile status of the trust follows that of the settlor. If the **non-domiciled trust holds foreign assets**, those assets are **excluded property** and transfers of such assets will **not** give rise to a UK IHT charge. IHTA 1984, s.6

Note that it is possible for trustees of offshore trusts to have an IHT exit charge on a distribution to a beneficiary, either if the settlor was UK domiciled or if the assets are situated in the UK.

If a testator creates a discretionary trust in his will, under s. 144 IHTA 1984, **any distributions from the trust within 2 years of death do not give rise to an IHT exit charge.** We covered this in the IHT chapter on Deeds of Variation. IHTA 1984, s.144

There are two elements to the calculation of the exit charge.

(i) Identify the "loss to trust" IHTA 1984, s.65(2)

We first ascertain the reduction in the amount of the relevant property as a result of the transfer. This is the "**loss to trust principle**" – i.e. the amount by which the value of the assets in the trust falls as a result of the distribution. If the distribution is one of cash, the loss to trust is simply the value of the cash transferred.

(ii) Identify the "actual rate of tax" IHTA 1984, s.68

Having arrived at the reduction in the relevant property, we multiply this by the "**actual rate**" of tax. The computation of the actual rate of tax is quite complex and we shall illustrate this below.

To calculate the actual rate of tax, we look at the IHT history of the settlor. The actual rate of tax is affected by the **settlor's cumulative chargeable transfers in the 7 years before the creation** of the trust, and by **any other trusts set up by the settlor on the same day** (related trusts).

To calculate an actual rate we must first arrive at an "**effective rate**".

Having arrived at the effective rate, we multiply this by 30%. Finally, we multiply by the fraction n/40, where "n" is the number of **complete quarters** that have elapsed **between the creation of the trust and the date of the exit charge.**

Actual Rate = Effective Rate x 30% x n/40 IHTA 1984, s.68(2)

A "quarter" in this instance means a completed 3-month calendar period. As we are calculating exits **before the first principal charge**, the maximum amount of completed quarters between the creation of the trust and the exit, is 39. Therefore the actual rate of tax will increase as we move closer to the next 10 year anniversary.

Calculating the "effective rate" IHTA 1984, s.68(4)

Before we calculate the actual rate, we first calculate the **effective rate**.

The effective rate is a **notional rate of tax** which would be charged on the settlor at the date of the exit charge, assuming the settlor had made a "notional transfer of value". That "notional transfer" is equal to the **initial value of this discretionary trust, plus the initial value of a related trust.** In essence we are pretending that the settlor made a transfer of value, and on that "pretend transfer" he paid some notional IHT. We need to calculate the effective rate of tax that applies to that notional IHT.
A proforma for computing the exit charge is given below.

Exit charge proforma;

	£	£
Initial value of relevant property		A
Initial value of related trust		B
		C
Nil band at date of exit	D	
Less: Settlor's chargeable transfer in 7 years before creation of trust	(E)	
Nil band remaining		(F)
		G
Notional IHT (G x 20%)		NT

Effective rate: = $\frac{NT}{C}$ x 100 ER (%)

Actual rate: ER x 30% x $\frac{n}{40}$ AR (%)

n = completed quarters between date of commencement and date of exit

Exit charge = "Loss to trust" x AR (%)

At first sight, these exit charge rules can appear quite intimidating. However, once you have become accustomed to the proforma below and attempted a few practice questions, you will see that the calculation is not as daunting as you might think.

Illustration 1

Graham set up a discretionary trust on 5 September 2003. Graham settled cash of £500,000 on the trust. He had made no other lifetime transfers. On the same day, Graham settled £120,000 in cash on to an accumulation and maintenance trust for his nieces and nephews.

On 12 October 2010, the trustees of the discretionary trust appointed £80,000 in cash to a beneficiary. The cash in the discretionary trust is "relevant property". As there has been a reduction in the value of this relevant property in October 2010, an exit charge will arise as calculated below:

	£
Initial value	500,000
Related trust	120,000
	620,000
Less nil band 2010/11	(325,000)
	£295,000
Notional IHT @ 20%	£59,000
Effective rate = $\frac{59000}{620000}$ x 100	9.516%
Actual rate = 9.516% x 30% x $\frac{28}{40}$ =	1.998%
Exit charge = £80,000 x 1.998% =	£1,598

Note there is no formal requirement to round any decimal fraction to three places, although for convenience sake this is acceptable. The maximum possible effective rate can never exceed 20%. An effective rate of 20% will apply if the whole of the nil band has been extinguished by chargeable transfers in the 7 years before the creation of the trust.

In calculating the "n" we are only interested in completed quarters, so any partial quarters are ignored.

The **due date** for payment of the tax is the **same as the due date for normal chargeable lifetime transfers.** In this instance it is either 6 months from the end of the month of the gift, or 30 April in the following tax year whichever is later. In this instance the due date is 30 April 2011. IHTA 1984, s.226

6.5 Initial values

IHTA 1984, s.68(5)

The amount of IHT payable on an exit is dependent on the **initial value** of the trust.

The initial value of the trust is the **value of all assets comprised in the trust immediately after the settlement**. This initial value will be **reduced if inheritance tax** on the chargeable lifetime transfer is **payable by the trustees**.

In the previous example, Graham gave £500,000 in cash to a discretionary trust, and we assumed that the initial value of the trust was £500,000. The initial value would have been £500,000 if Graham had paid the tax on the chargeable lifetime transfer. If Graham had asked the trustees to pay the tax, we would have had to calculate the IHT due and deduct this from the £500,000 to arrive at the initial value.

Therefore for the purposes of calculating this initial value, a calculation of the lifetime inheritance tax is only necessary if the tax is to be borne by the trustees.

Initial value of trust = (Assets settled – IHT paid by trustees)

When calculating the initial value of the trust, we **ignore business or agricultural property relief.** BPR or APR may affect the tax payable on the chargeable lifetime transfer, but it does not alter the trustees' initial value.

Therefore in the previous illustration, if Graham had transferred £500,000 worth of shares in an unquoted trading company to the discretionary trust, no IHT would have been payable as the transfer would have been wholly covered by BPR. However, for the purposes of calculating the exit charge, the initial value of the trust would be £500,000. The initial value of the trust is the value of the assets in the trust immediately after the creation. Whether those assets are business or agricultural property is irrelevant.

When calculating lifetime IHT on gifts to a discretionary trust, we work out the **loss to the donor's estate** as a result of the transfer. We also need to take account of **related property** – i.e. similar assets held by one's spouse. These concepts are **irrelevant** for calculating the initial value. The initial value is the value of the assets within the trust, valued on a "**stand alone**" or "isolated" basis.

The value transferred by the donor for IHT purposes, may therefore be different to the initial value of the trust for exit charge purposes.

Finally, we must decide who will pay the tax on the exit charge. If the tax on the exit is to be **borne by the beneficiary**, to calculate the exit charge we **use the actual rate**. This is what we did in the previous example. We took the property which was leaving the trust – i.e. £80,000 – and multiplied it by the actual rate of 1.998%.

However, if the **trustees agree to pay** the tax on the exit, in order to work out the exit charge we must first **"gross up" the actual rate**. We gross up in order to recognise that if the trustees pay the tax on the exit, the loss to the trust as a result of the distribution is not just the distribution, it is also the inheritance tax payable by the trustees.

We can liken this to the way that we calculate IHT on a chargeable lifetime transfer if the donor pays the tax. In this instance we do not simply use the lifetime rate of 20%. Instead we gross this up and use a grossed up rate of 20/80.

Primary responsibility for paying the tax on an exit rests with the **trustees**, although they can delegate this responsibility to the beneficiary if they want to.

Illustration 2

We will revisit the previous illustration involving Graham. Graham set up a discretionary trust in September 2003 with £500,000 in cash, and a distribution to a beneficiary was made in October 2010. If the trustees had paid the tax on the chargeable lifetime transfer in September 2003, we would need to take this into account when computing the initial value.

	£
Gift	500,000
Less: AEs	(6,000)
Chargeable transfer	494,000
Less: Nil band 2003/04	(255,000)
Taxable	239,000
IHT @ 20%	£47,800

The tax payable by the trustees will affect the initial value of the trust. The initial value of the discretionary trust in September 2003 is therefore

£(500,000 – 47,800) = £452,200

We will then use this initial value to calculate the effective rate and the actual rate.

	£
Initial value £(500,000 – 47,800)	452,200
Related trust	120,000
	572,200
Less nil band at exit	(325,000)
	£247,200
Notional IHT @ 20%	£49,440
Effective rate: $\frac{49,440}{572,200} \times 100$	8.64%
Actual rate: $8.64\% \times 30\% \times \frac{28}{40}$	1.814%

Actual tax payable by trustees rate should be grossed up:

$\frac{1.814}{100-1.814} \times 100$	1.848%
Exit charge:	
£80,000 x 1.848%	£1,478

6.6 BPR & APR

Under general principles, BPR and APR reduce a chargeable transfer of value. When trustees make a distribution so as to reduce the value of relevant property in the trust, this is treated as a transfer of value for IHT purposes. **BPR and APR will therefore need to be considered when working out the tax on the exit.**

IHTA 1984, s.103
IHTA 1984, s.104
IHTA 1984, s.115

Remember that the exit charge is the actual rate of tax multiplied by the "loss to trust". This value transferred by the trustees can be reduced by APR and BPR to give a net chargeable transfer of value.

Loss to trust	X
Less: APR / BPR	(X)
Net chargeable transfer	X

It is this transfer of value - ie, after APR or BPR - which is multiplied by the actual rate to arrive at the exit charge. Therefore if the property leaving the trust is **wholly covered by 100% BPR or APR** – i.e. for example if shares in an unquoted trading company are being appointed to a beneficiary – **the exit charge will be zero**.

It is therefore always worth looking at the type of property leaving the trust, as it can be very frustrating calculating an actual rate of tax only to find that it is being multiplied by zero.

Trustees will be entitled to BPR or APR if they are transferring relevant business or agricultural property, and the **minimum ownership requirements have been satisfied.** Remember that BPR or APR will not be given if the assets have not been held for the minimum **2 year period**. IHTA 1984, s.106 IHTA 1984, s.117

Therefore if business property is transferred by a settlor to a trust, and the trustees distribute that business property before 2 years have elapsed, it is highly unlikely that BPR will be given.

Remember that whilst BPR or APR is taken into account when calculating the inheritance tax, **it does not affect the initial value of the trust**.

Example 1

Henry set up a discretionary trust in March 2002 with cash of £850,000. He had made a chargeable transfer of £125,000 in 1998. Henry paid any IHT on the creation of the trust.

In November 2010, the trustees appointed £120,000 to a beneficiary, Paul. Paul agreed to pay any IHT due.

Calculate the IHT due on the appointment in 2010.

Example 2

Joe died in January 2005. In his Will he left his entire estate (as below) to a discretionary trust:

Cash	£400,000
Farmland	£300,000

The farmland qualified for 50% APR. Joe's lifetime transfers totalled £500,000.

The trustees gave £100,000 in cash to a beneficiary in August 2010. The trustees paid the IHT.

Calculate the IHT due on the distribution in 2010.

Answer 1

	£	£
Initial value		850,000
Less nil band 2010/11	325,000	
Less CTs in 7 years pre trust	(125,000)	
Nil band remaining		(200,000)
		£650,000
Notional IHT @ 20%		£130,000
Effective rate = $\frac{130000}{850000} \times 100$		15.294%
Actual rate = $15.294\% \times 30\% \times \frac{34}{40}$		3.9%
Exit charge = £120,000 x 3.9%		**£4,680**

Answer 2

Tax on death estate:	£	£
Estate		700,000
Less APR (50% x £300,000)		(150,000)
Chargeable		550,000
Nil band at death	263,000	
Less CTs in prior 7 years	(500,000)	
Nil band remaining		(Nil)
Taxable		£550,000
IHT @ 40%		£220,000

	£	£
Initial value £(700,000 – 220,000)		480,000
Nil band at exit	325,000	
Less CTs in 7 years pre Jan 2005	(500,000)	
		(Nil)
		£480,000
Notional tax @ 20%		£96,000
Effective rate = $\frac{96000}{480000} \times 100$		20%
Actual rate = $20\% \times 30\% \times \frac{22}{40}$		3.3%

IHT on exit charge paid by trustees $\therefore$ gross up

$$3.3\% \longrightarrow \frac{3.3}{100 - 3.3}$$ 3.413%

Exit charge: £100,000 x 3.413% **£3,413**