CHAPTER 8

DISCRETIONARY TRUSTS – ADDED PROPERTY

8.1 Additions to discretionary trusts

An addition to a discretionary trust by the original settlor will affect an exit charge within the first 10 years of the trust.

An exit charge is dependent on the initial value of property in the trust. We also need to include the initial value of a related trust. We also need to **take account of the initial value of any property added to the trust by the same settlor**, before the exit took place. The initial value of both the initial property and the addition, will be affected by who pays the IHT on the transfer. It is not affected by any BPR or APR.

The exit charge proforma is as follows:

		£
Initial value of trust		A
Initial value of a related trust		B
Initial value of an addition to the trust		C
		D
Nil band at exit	NB	
Less:		
Chargeable transfers in 7 years before creation	(CTs)	
		(NB)
		X
Notional tax @ 20%		NT
Effective rate: $\frac{NT}{D} \times 100$		ER%
Actual rate: ER x 30% x $\frac{n - x}{40}$		AR%

Where:

n = completed quarters between creation of trust and date of exit;

x = completed quarters between creation of trust and date of addition (assuming the exit comes from the added property).

We **deduct the number of completed quarters** in the period **from the date of creation to the date of the addition** because the added property was not within the trust during this period. IHTA 1984, s.68(3)

These rules only apply when property is added to the trust by the original settlor. If property is added by a **different settlor**, that settlor is treated as having created a **separate trust** as at the date of the addition.

Illustration 1

Graham created discretionary trust in January 2001 with £500,000 in cash. The settlor agreed to pay the inheritance tax arising.

In March 2005, Graham added £300,000 of quoted shares to the trust. Again, the settlor paid the IHT due. These were Graham's only transfers.

In May 2010, the trustees distributed £100,000 of the quoted shares to a beneficiary. This will give rise to an IHT exit charge.

We will illustrate how the addition in 2005 affects the IHT due.

	£
Initial value of trust	500,000
Initial value of a related trust	-
Initial value of addition to trust	300,000
	800,000
Nil band at exit	(325,000)
	475,000
Notional tax @ 20%	£95,000
Effective rate: $\frac{95000}{800000} \times 100$	11.875%
$\frac{1}{4}$s between 1.1.01 – 1.5.10 =	37
$\frac{1}{4}$s between 1.1.01 – 1.3.05 =	16
Actual rate: $11.875\% \times 30\% \times \frac{37 - 16}{40}$	1.870%
Exit charge (assume beneficiary pays tax):	
£100,000 x 1.87% =	£1,870

8.2 Additions – effect on principal charge

An addition to the trust in the first 10 years, will also affect the tax payable on the first principal charge. The principal charge is based on the value of relevant property in the trust on the tenth anniversary. This value will **include any property added** to the trust in the previous 10 years.

However as this added property will not have been within the trust for the entire period of 40 quarters, we will need to make an appropriate adjustment when calculating the actual rate. IHTA 1984, s.66(2)

When calculating the principal charge, **2 different actual rates will apply**:

(i) the rate of tax applying to the original property, will be:

$$ER \times 30\% \times \frac{40}{40}$$

(ii) The actual rate applying to the added property will need to be adjusted, i.e. $ER \times 30\% \times \frac{40 - x}{40}$, where "x" = $\frac{1}{4}$s between creation and addition.

This is a similar adjustment to that which we made when calculating the exit charge.

Illustration 2

Returning to the example of Graham, the first principal charge will take place in January 2011. The trust was created with £500,000 of cash in January 2001. Quoted shares were added to the trust in 2005, and £100,000 of those shares left the trust in 2010.

The principal charge is based on the value of the trust assets in January 2011. We need to differentiate between the value of the original property and the value of the quoted shares. The cash is still in the trust, being worth £500,000, while the quoted shares are worth £250,000.

The principal charge is as below:

		£
Value of trust at January 2011:		
Original property (cash)		500,000
Added property (shares)		250,000
		750,000
Nil band 2010/11	325,000	
Less: chargeable transfers in 7 years before creation	(Nil)	
Less: distributions in the last 10 years	(100,000)	
		(225,000)
		525,000

Notional tax @ 20%	£105,000
Effective rate: $\frac{105000}{750000} \times 100$	14%
$\frac{1}{4}$s between creation and principal charge =	40
$\frac{1}{4}$s between creation and addition	16
Actual rate applying to original property:	
$14\ \% \times 30\% \times \frac{40}{40}$	4.2%
Actual rate applying to added property:	
$14\ \% \times 30\% \times \frac{40 - 16}{40}$	2.52%
Principal charge:	£
On original property: £500,000 x 4.2%	21,000
On added property: £250,000 x 2.52%	6,300
	£27,300

You will appreciate that this computation could get quite complex if the settlor has made several additions in the 10 years before the principal charge. In this case, a different actual rate would apply to each different amount of added property.

8.3 Adjustment to settlor's cumulative total

An addition of property to a discretionary trust, will **also affect the settlor's cumulative total** brought forward which is used in calculating the actual rate to be applied on a principal charge. The cumulative total is as follows:

	£
Settlor's chargeable transfers in 7 years before creation of trust	X
Distributions from trust in preceding 10 years	X
	X

However this cumulative total may need to be adjusted if the settlor had added property to the trust before the principal charge. In this case we **compare** the settlor's transfers in the **7 years before the trust** was set up to the settlor's transfers in the **7 years before the addition, ie:**

IHTA 1984, s.67(3)

	£
Settlor's chargeable transfers in 7 years before **addition** to trust	X
Distributions from trust in preceding 10 years	X
	X

We **take whichever is the HIGHER**.

Note:

Settlor's chargeable transfers in 7 years before the addition to the trust do NOT include:

- the chargeable transfer on the creation of the trust; or
- transfers to related trusts.

Illustration 3

Catherine created the Alpha Discretionary trust in September 2001. This was her first ever transfer. There were no exits in the first 10 years, so the first IHT event will be the principal charge in September 2011.

Catherine added property to the Alpha Trust in July 2006. Her only other transfer had been to create a separate discretionary trust (the Beta trust) with £100,000 in cash in March 2002. Her annual exemptions had been used against the transfer in September 2001.

This will have an effect on the cumulative total as follows:

Settlor's transfers in 7 years prior to creation of Alpha Trust	Nil
Settlor's transfers in 7 years prior to addition to Alpha trust in July 2006	£100,000

Therefore the settlor's cumulative total is £100,000.

Effect on principal charge (September 2011):

	£
Nil band 2011/12	325,000
Less: Cumulative transfers b/fwd	(100,000)
Nil band available	225,000

For planning purposes, as the addition to a discretionary trust in 2006 has had the effect of using up the nil band and thereby increasing the effective rate, Catherine would have been **better advised to have settled the property onto a separate trust.** This would not be an addition to the Alpha trust, and would not be taken into account when calculating the principal charge.

8.4 Additions to discretionary trusts – practical issues

There could be a practical problem, if the property leaving the discretionary trust after an addition cannot be separately identified. This will be the case if the **original property and the added property are the same** (typically on transfers of cash).

To calculate the tax payable on the exit, we apportion the distribution between the original and the added property on a "just and reasonable" basis.

Illustration 4

A discretionary trust was created with £400,000 in cash. A few years later, cash of £100,000 was added to the trust. Therefore, 4/5^{ths} of the trust value relates to the original property, and 1/5th to the added property.

Cash of £50,000 was later distributed to a beneficiary.

We apportion on a "just and reasonable" basis, which means that 4/5ths of the cash distributed is deemed to derive from the original property. The cash has been in the trust since creation, therefore we multiply the actual rate by $\frac{n}{40}$

One-fifth of the distribution is deemed to have come from the added property. Therefore, when calculating the actual rate, we will need to adjust the quarters to reflect the fact that this cash was not in the trust since creation. We will therefore have two exit charges, which we will add together. A similar apportionment will have to be made when it comes to calculating the principal charge.

Example 1

Oliver set up a discretionary trust on 1 October 2000 with £750,000 in cash. He added a further £250,000 in cash to the trust in September 2008. Oliver paid the IHT arising on both transfers. He made no other lifetime gifts.

On 13 July 2010, the trustees appointed £200,000 to a beneficiary.

Calculate the inheritance tax payable by the beneficiary on the distribution.

Example 2

Oliver set up a discretionary trust on 1 October 2000 with £750,000 in cash. He added a further £250,000 in cash to the trust in September 2008. Oliver paid the IHT arising on both transfers. He made no other lifetime gifts.

On 13 July 2010, the trustees appointed £200,000 to a beneficiary. The beneficiary paid any IHT arising.

On 1 October 2010, the trust assets were valued at £925,000.

Calculate the inheritance tax payable on the 10-year anniversary.

Answer 1

	£
Initial value (October 2000)	750,000
Initial value of addition	250,000
	1,000,000
Nil band 2010/11	(325,000)
	675,000
Notional tax @ 20%	£135,000
Effective rate: $\frac{135000}{1000000} \times 100$	13.5%
$\frac{1}{4}$s between creation and exit (1.10.00 – 13.7.10)	39
$\frac{1}{4}$s between creation and addition (1.10.00 – 1.9.08)	31
Actual rate applying to original property: $13.5\% \times 30\% \times \frac{39}{40}$	3.949%
Actual rate applying to added property: $13.5\% \times 30\% \times \frac{39 - 31}{40}$	0.81%
Exit charge:	£
Distribution of original property: $£200{,}000 \times \frac{750}{750 + 250} = £150{,}000 \times 3.949\%$	5,923
Distribution of added property: $£200{,}000 \times \frac{250}{750 + 250} = £50{,}000 \times 0.81\%$	405
Total exit charge	**£6,328**

Answer 2

	£	£
Relevant property (October 2010)		925,000
Nil band 2010/11	325,000	
Less: distributions in last 10 years	(200,000)	
		(125,000)
		800,000
Notional tax @ 20%		160,000
Effective rate: $\frac{160000}{925000} \times 100$		17.298%
$\frac{1}{4}$s between creation and addition (1.10.00 – 1.9.08)		31
Actual rate applying to original property: $17.298\% \times 30\% \times \frac{40}{40}$		5.189%
Actual rate applying to added property: $17.298\% \times 30\% \times \frac{40 - 31}{40}$		1.1675%
Principal charge:		£
On original property: $£925,000 \times \frac{750}{750 + 250} = £693,750 \times 5.189\%$		35,999
On added property: $£925,000 \times \frac{250}{750 + 250} = £231,250 \times 1.1675\%$		2,700
Total exit charge		**£38,699**