CHAPTER 9

DISCRETIONARY TRUSTS – FURTHER ASPECTS

9.1 Non-relevant property – effect on exit charges

When calculating an exit charge in the first 10 years of the trust, the effective rate of tax is calculated using "the value immediately after the settlement commenced of property then comprised in it" (S.68(5)(a)) – ie, the initial value. This initial value will include **all** assets entering the trust **even if those assets are not relevant property at that time**. The same principle applies to any added property. IHTA 1984, s.68(5)

Illustration 1

Joe created a trust on 15 May 2002 with £800,000 in cash. The terms of the trust were that Joe's daughter, Tina, was entitled to an interest in possession in 25% of the fund, with the remainder held on discretionary trust for Joe's grandchildren. Joe had made no lifetime transfers prior to 2002 and the trustees paid any IHT arising.

In July 2011 the trustees made a discretionary distribution of £25,000 to each of Joe's 4 grandchildren. The trustees paid any IHT arising.

Calculate the IHT on the discretionary distribution.

i) Tax on creation;

Joe is treated as creating 2 separate trusts on 15 May 2002 as follows:

	DT	IIP
	£	£
Gift (75:25)	600,000	200,000
Less: 2 x AEs (split pro-rata)	(4,500)	(1,500)
	595,500	198,500
	= CLT	= PET

Gifts to IIP trusts prior to 22 March 2006 were PETs. Therefore only the gift to the discretionary part of the trust would have been liable to IHT;

	£
CLT	595,500
Less; nil band 2002/03	(250,000)
Taxable	345,500
IHT @ 20%	69,100

ii) The exit charge is as follows:

	£
Initial value of trust:	
Relevant property £(600,000 – 69,100)	530,900
Non-relevant property (IIP)	200,000
	730,900
Less: nil band at exit	(325,000)
	405,900
Notional tax @ 20%	81,180
Effective rate: $\frac{81180}{730900} \times 100$	11.107%
Actual rate: 11.107% x 30% x $\frac{36}{40}$	3%
Gross-up as Trustees pay tax:	
$\frac{3}{100-3} \times 100$	3.093%
Exit charge:	
£(25,000 x 4) = £100,000 x 3.093%	£3,093

The effect of creating a trust containing non-relevant property is therefore the same as having set up 2 different trusts on the same day – ie, **the rule mirrors that which applies to related trusts**.

Joe would have been better advised to have created a separate IIP trust for Tina on the day **after** he had set up the discretionary trust (ie, 16 May 2002). This would have reduced the lifetime tax on the CLT (as all AEs would have been allocated to the first transfer) and would have reduced the rate of tax applying to the exit charge.

9.2 Non-relevant property – effect on principal charges

Only relevant property within the trust on its 10-year anniversary will be subject to the principal charge.

However to calculate the effective rate of tax we must take account of "the value immediately after it became comprised in the settlement, of any property which was not then relevant property and has not subsequently become relevant property" (S.66(4)(b)) – ie, we take the **initial value of any non-relevant property** in the trust. IHTA 1984, s.66(4)

Again this rule **mirrors that for related trusts** where the initial value of a related trust affects the rate of tax on a principal charge.

Illustration 2

Returning to the example of Joe's trust (above).

At 15 May 2012 the trust was valued at £1.2 million of which Joe's daughter Tina had an interest in possession in 25%.

Calculate the Principal Charge.

The principal charge is as follows:

		£
Relevant property at May 2012 (£1.2m x 75%)		900,000
Initial value of non-relevant property		200,000
		1,100,000
Nil band at exit	325,000	
Less: distributions in last 10 years £(100,000 + 3,093)	(103,093)	
		(221,907)
		878,093
Notional tax @ 20%		175,619
Effective rate: $\frac{175619}{1100000} \times 100$		15.965%
Actual rate: 15.965% x 30%		4.79%
Principal charge: £900,000 x 4.79%		**£43,110**

9.3 Excluded property trusts

A trust is domiciled **where the settlor was domiciled when he created the trust**. Therefore a trust created by an individual not domiciled in the UK will be non-UK domiciled for IHT purposes.

The trust will remain non-UK domiciled even if the settlor subsequently acquires a UK domicile (either under general law or under the 17-year residence rule in S.267 IHTA 1984).

Foreign assets held by a non domiciled person are "excluded property". Excluded property is outside the scope of IHT. Therefore any transfers of excluded property are ignored for IHT purposes. IHTA 1984, s.48(3)

As such, **foreign assets held by a trust which is non-UK domiciled are excluded from a charge to IHT**.

Note that a **trust can be resident in the UK but can still be an excluded property trust** for IHT. This can happen if a non-UK domiciled person creates a trust by settling (say) shares in a foreign company. The settlor appoints 2 trustees, both of whom live in the UK. The trust is therefore UK resident but non-UK domiciled. The foreign assets held by the trustees are not therefore subject to IHT.

This means that;

i. there will be **no exit charge if those foreign assets are distributed to beneficiaries** (even if the beneficiaries are UK resident and/or domiciled); &

ii. the **foreign assets in the trust are not subject to principal charges**.

If a non-domiciled trust has a mixture of UK and foreign assets, the **UK assets will not be excluded property** and will be subject to exit and principal charges.

For tax planning purposes, trusts with a non-UK domiciled settlor can avoid an IHT charge by (say) exporting assets prior to either a capital distribution or a principal charge.

For example, switching cash from a UK bank to an offshore account just before the 10-year anniversary will save IHT.

9.4 Excluded property – effect on exit & principal charges

Excluded property is not "relevant property". Therefore if a trust contains excluded property, **those assets are treated as "non-relevant property" for exit and principal charge purposes**. The initial value of any excluded property will therefore have to be taken into account when calculating the rate of tax to be applied on an exit or principal charge (as in illustrations 1 & 2 above).

Illustration 3

Mr Ashcroft is resident in the UK but domiciled in Belize. He has lived in the UK since March 1990. In June 2001 he settled the following assets on to a discretionary trust for the benefit of his wider family (himself excluded);

	£
House in Belize	400,000
Cash in Belizean dollars (deposited into a Cayman Islands bank)	300,000
UK quoted shares	240,000
Total	940,000

In September 2009, the trustees made a capital distribution of BZ$100,000 (£50,000 sterling equivalent) to a UK beneficiary.

In June 2011, the trust assets were valued as follows;

	£
House in Belize	600,000
Cash in Belizean dollars (held in a Cayman Islands bank account)	400,000
UK quoted shares	300,000
Total	1,300,000

The IHT implications of the above arrangements are as follows;

- In June 2001 when he set up the trust, Mr Ashcroft was non-UK domiciled. Mr Ashcroft would only therefore have been liable to IHT in respect of transfers of UK assets (his foreign assets were excluded property). The chargeable transfer in 2001 was therefore £240,000 being the UK shares only. This would have been covered by the nil band for 2001/02 leaving no tax payable.
- The trust is non-UK domiciled. The fact that Mr Ashcroft will have become deemed domiciled in 2006/07 (on account of having been resident in the UK for 17 years) will not change the domicile status of the trust.
- The distribution of Belizean dollars to the UK beneficiary in September 2009 will not give rise to an exit charge as the Belizean bank account is excluded property. The fact that it is paid to a UK beneficiary is irrelevant.
- There will be a principal charge in 2011, but IHT will be charged on the UK assets only (being the UK quoted shares of £300,000).

The principal charge is as follows:

		£
Relevant property at June 2011		300,000
Initial value of non-relevant property £(400,000 + 300,000)		700,000
		1,000,000
Nil band at exit	325,000	
Less: chargeable distributions in last 10 years	(NIL)	
		(325,000)
		675,000
Notional tax @ 20%		135,000
Effective rate: $\frac{135000}{1000000} \times 100$		13.5%
Actual rate: 13.5% x 30%		4.05%
Principal charge: £300,000 x 4.05%		£12,150

Note that even though only the UK assets are charged to IHT in 2011, **the initial value of the excluded property (being "non-relevant property") must be taken into account to calculate the rate of tax.** Therefore even though the trust is non-UK domiciled and has UK assets of less than the IHT nil band, a principal charge still arises.

To avoid the charge, the trustees could have sold the UK shares and transferred the proceeds to an overseas account (although CGT would then need to be considered).

9.5 Trusts becoming discretionary

It is possible for a non-discretionary trust to be converted into a discretionary trust. For example, a settlor could have created an interest in possession trust before March 2006, under which the property passes to a discretionary trust on the death of the life tenant. If property is later distributed from the discretionary trust, an exit charge will arise. Similarly there will be a principal charge on each 10-year anniversary.

The **date of commencement** of the trust for IHT purposes, is the date on which **property first becomes comprised in the settlement**. The date of commencement is therefore the date that the **interest in possession trust was created.** Therefore the principal charges will fall on each 10 year anniversary from the creation of the interest in possession trust. IHTA 1984, s.60

When calculating the IHT on the exit charge, we must **adjust the number of quarters** to reflect that the trust assets have not been relevant property for the full period.

IHT is only charged on "relevant property", and in the period before the discretionary trust came into being, the trust assets were not "relevant property". Therefore when calculating the actual rate on the exit charge, we **adjust the quarters as we did for added property**. We will do a similar exercise when computing the principal charge.

Illustration 4

Leo created an interest in possession trust for his son on 1 April 2001 with £600,000 in cash. His chargeable transfers in the previous 7 years were £163,000. Leo's son died on 15 June 2005 and the trust instrument directed that the property be thereafter held on a discretionary trust.

On 21 October 2008, the discretionary trustees appointed cash of £75,000 to a beneficiary. We will calculate the exit charge below.

The first principal charge will fall on 1 April 2011, being 10 years from the date of the original settlement. Trust assets are worth £900,000 at this point. We will also calculate the principal charge.

(a) Exit charge (21.10.08)

$\frac{1}{4}$s between creation of interest in possession trust (1.4.01) and date of exit = 30

$\frac{1}{4}$s between creation of interest in possession trust (1.4.01) and establishment of discretionary trust (15.6.05) = 16

	£	£
Initial value (1.4.01)		600,000
Nil band at exit (2008/09)	312,000	
Less: chargeable transfers in 7 years before creation of trust	(163,000)	
		(149,000)
		451,000
Notional tax @ 20%		90,200
Effective rate: $\frac{90200}{600000} \times 100$		15.033%
Actual rate: $15.033\% \times 30\% \times \frac{30-16}{40}$		1.5785%
Exit charge (assume tax paid by beneficiary); £75,000 x 1.5785%		£1,184

(b) Principal charge (1.4.11)

		£
Value of trust at 1.4.11		900,000
Nil band 2010/11	325,000	
Less: chargeable transfers in 7 years pre-trust	(163,000)	
Less: distributions in the previous 10 years	(75,000)	
		(87,000)
		813,000
Notional tax @ 20%		162,600
Effective rate: $\frac{162600}{900000} \times 100$		18.067%
Actual rate: $18.067\% \times 30\% \times \frac{40 - 16}{40}$		3.252%
Principal charge: £900,000 x 3.252%		£29,268

9.6 Section 80 IHTA 1984

Section 80 IHTA 1984 applies where: IHTA 1984, s.80

1) the **settlor or their spouse had an interest in possession** in property; &
2) on their death (or other termination of the IIP), the **property becomes held on a discretionary trust.**

For trusts created on or **after 22 March 2006**, s.80 only applies if the settlor creates a trust on **death of which his spouse/civil partner has an interest in possession**. IHTA 1984, s.80(4)

The effect of Section 80 is twofold;

1) **trusts within Section 80 are not "related settlements"** for the purpose of calculating exit and principal charges; &

2) the property now held on discretionary trust is **treated as a separate trust made by the person who was last entitled to an IIP** in it.

This means that the **settlor of the trust is regarded as the last of either the settlor or his spouse to have an interest in possession**. This is important for exit and principal charge purposes because;

1) it is the settlor's "clock" we take account of when calculating the effective rate; and
2) the initial value" of the trust for exit charge purposes, is the value of the trust assets at the date the **settlor is deemed to have created the trust** (ie, we use the **value at the date the trust became discretionary**).

However, even if Section 80 applies, **principal charges** are determined by the **date of the original settlement** – i.e., the date the interest is possession trust was created (not the date that the trust became discretionary). Therefore we will need to **adjust the number of quarters** when calculating a principal charge.

Illustration 5

Mr Jensen died on 1 August 2001. He made no lifetime transfers. His will directed that his estate (then worth £500,000) be held on interest in possession trust for his wife, with remainder to a discretionary trust for his children and grandchildren on his wife's death.

Mrs Jensen died in September 2004, and the assets of the trust (then valued at £600,000) thereafter became held on a discretionary trust. She had made lifetime transfers of £125,000 in the 7 years before her death.

The trustees made a capital distribution of £80,000 to a beneficiary in November 2010.

Solution

1. **The date of commencement for principal charge purposes is 1 August 2001**. The **first** principal charge will therefore be levied on 1 August 2011. We would then need to **adjust the quarters** to reflect the fact that the property was not "relevant property" between August 2001 and September 2004.

2. F**or all other purposes**, the discretionary trust is treated as having been created by **Mrs Jensen in September 2004**. Mrs Jensen is therefore the settlor of the trust. This means that to calculate the exit charge in November 2010;

   a) the initial value we use is that as at **September 2004** (ie £600,000 less any IHT paid by the trustees); &

   b) we use **Mrs Jensen's cumulative total of transfers** (ie £125,000) to calculate the effective rate of tax; &

   c) when calculating the effective rate, the number of completed quarters runs from **September 2004 to November 2010 being 24**.

9.7 Protective trusts

IHTA 1984, s.88

A "protective" trust is an interest in possession trust, under which a beneficiary has a right to income. However, under the terms of the trust, the interest will terminate either if the life tenant becomes bankrupt or if he tries to dispose of his interest in possession. Such trusts are typically established where a settlor does not have full confidence that the beneficiary will deal responsibly with his interest in possession.

On the **termination of the life interest**, the trust property thereafter becomes settled on to a **discretionary trust for the benefit of the life tenant and his immediate family.** The life tenant no longer has a right to income as it arises, and instead the trustees can deal with the trust property at their discretion.

For inheritance tax purposes, the interest in possession is deemed to continue. This means that the **value** of the trust will **still be treated as a "qualifying interest in possession"** in the estate of the previous life tenant in the event of his death (see Chapter 12 for further details).

As the trust is not a relevant property trust for IHT purposes, **no exit or principal charges** will arise. If the trustees make a **capital distribution** to a beneficiary, this will be treated as a **distribution by the life tenant**, and in most instances will be a potentially exempt transfer for IHT purposes.

Example 1

Mr Darling died on 16 September 2000. He had made no lifetime transfers.

His will directed that his estate be divided as follows;

- £250,000 on a qualifying Accumulation & Maintenance (A&M) Trust for his 3 teenage nephews;
- £900,000 on discretionary trusts for his children. The terms of the trust are that his wife, Grace, would have an interest in possession for life in one-third of the trust with capital reversion to their grandchildren on her death;
- The residue of the estate to be divided equally between their 6 grandchildren.

Grace Darling died on 3 January 2006.

On 5 April 2008, the assets in the A&M trust for the nephews were fully appointed to the beneficiaries and the trust was wound up.

On 16 September 2010, the discretionary trust was valued at £850,000. No prior capital distributions had been made.

Calculate the Principal Charge arising in September 2010.

Example 2

Mr Becker lives in the UK but is domiciled in Germany. On 6 April 2002 he created a trust for his only child, Benjamin, under which Benjamin will receive capital at age 18 (until then, income and capital will be distributed at the discretion of the trustee). This was Mr Becker's only transfer. Mr Becker is the sole trustee.

The assets settled in 2002 were UK quoted shares (valued at £250,000) and an investment property in Germany (valued at £600,000).

Benjamin was 18 on 7 October 2010 at which point the shares (then worth £450,000) and the investment property (then worth £575,000) were transferred to him. Benjamin paid any tax arising.

Calculate the IHT due (if any) on the transfer to Benjamin in October 2010.

Answer 1

	£
Relevant property at September 2010	850,000
Initial value of related trust	250,000
Initial value of non-relevant property (£900,000 x 1/3)	300,000
	1,400,000
Less: Nil band at principal charge	(325,000)
	1,075,000
Notional tax @ 20%	215,000
Effective rate: $\frac{215000}{1400000} \times 100$	15.357%
Actual rate: 15.357% x 30%	4.607%
Principal charge: £850,000 x 4.607%	**£39,160**

Answer 2

The trust is non-UK domiciled as the settlor was non-domiciled when he created the trust.

The foreign assets in the trust are therefore excluded property and will not be liable to an exit charge. However the initial value of the excluded property will need to be taken into account to calculate the rate of tax.

The exit charge is therefore;

	£
Initial value of trust £(250,000 + 600,000)	850,000
Less: nil band at exit	(325,000)
	525,000
Notional tax @ 20%	105,000
Effective rate: $\frac{105000}{850000} \times 100$	12.353%
Actual rate: 12.353% x 30% x $\frac{34}{40}$	3.15%
Exit charge (UK assets only): £450,000 x 3.15%	**£14,175**