CHAPTER 18

SETTLOR INTERESTED TRUSTS – CGT & IHT

18.1 Capital gains tax

In this chapter we shall look at the special rules for settlor interested trusts as they apply for inheritance tax and capital gains tax. We will start with capital gains tax.

Prior to the reform of capital gains tax in FA 2008, the gains arising in a "settlor interested" trust were charged on the settlor rather than the trustees. This legislation has now been repealed, as the rules are no longer considered necessary.

The only remaining CGT provision on "settlor interested" trusts relates to the availability of gift relief.

18.2 Settlor "interests"

For CGT purposes, a settlor is treated as having an interest in a settlement if any of the following may benefit from the trust:

TCGA 1992, s.169F

a) the settlor;
b) the settlor's spouse;
c) a "dependent child" (or step child) of the settlor (aged under 18 & unmarried).

18.3 Gift Relief

If a settlor transfers assets to a trust on or after 10 December 2003 and the **settlor has an interest** in a trust (see above), **gift relief is prohibited.**

Therefore the settlor will have a chargeable gain on the settlement, which cannot be deferred.

18.4 Inheritance tax issues

The inheritance tax implications of a settlor being a beneficiary of a trust that he or she creates, depend largely on the type of trust created.

(i) Interest in possession trusts

First let us look at a situation where a settlor creates an interest in possession trust and the **settlor is also the life tenant**.

IHTA 1984, s.49

For IHT purposes, in trusts created before 22 March 2006, the life tenant of an interest in possession trust is treated as being entitled to the underlying trust assets. On the life tenant's death, the value of the trust assets will be "settled property" within his death estate.

Therefore if a settlor created an interest in possession trust for himself, he was **not regarded as having made a transfer of value** for IHT purposes. There has been no loss to his estate as a result of the transfer. Before the transfer, the assets formed part of his free estate, and after the transfer the assets were still within his death estate, this time as settled property. As there has been no fall in value as a result of the transfer, there were **no inheritance tax implications**.

For trusts created on or after 22 March 2006, the rules relating to discretionary trusts will apply (see below).

(ii) Discretionary trusts

Moving to anti-avoidance rules where a **settlor creates a discretionary trust of which he is a beneficiary**.

Regardless of the fact that the settlor is a beneficiary, the gift to the discretionary trust is a **chargeable lifetime transfer**, and IHT may be due on the creation of the trust. There is a loss to the donor's estate because the settlor, being a beneficiary of a discretionary trust, is not treated as owning the underlying assets of the trust for IHT purposes.

IHTA 1984, s.2

However, if a settlor creates a discretionary trust and is thereafter still able to benefit from the property given away, this will be **regarded as a gift with reservation of benefit**. This will be the case regardless of whether the settlor actually receives any benefit from the discretionary trust – the fact that he is capable of benefiting, means that the gift with reservation rules will apply.

FA 1986, s.102

This means that on the death of the settlor, the assets of the trust will be deemed to form part of his death estate. To prevent there from being any double taxation, any lifetime tax paid by the settlor or trustees can be deducted from the IHT payable by the executors of the estate.

If the settlor dies within 7 years of creating the trust, a "double charges" situation will arise. This is because, under the gift with reservation rules, the trust assets form part of the settlor's death estate. Also, there is an additional charge on the chargeable lifetime transfer made within 7 years of death.

SI 1987/1130

In this case, normal double charges rules will apply. HMRC will prepare two sets of IHT calculations and take whichever produces the highest amount of tax.

18.5 Miscellaneous points

For those drafting trust deeds, it is vital to draft the instrument very carefully to **ensure that the settlor or his spouse cannot benefit in any circumstances whatsoever**.

It is not sufficient to simply include a clause saying that the settlor or spouse shall be excluded from benefiting from this trust. For example, if circumstances conspire such that any of the settled property can revert to the settlor or the settlor's spouse/civil partner – for example on the trust failing – HMRC can argue that the settlor could possibly benefit from the trust, and that the anti-avoidance rules should be invoked.

Finally, even if a settlor can benefit from a discretionary trust or an interest in possession trust created after 22 March 2006, **exit and principal charges will arise as normal**.

Example 1

Paul bought shares (a 1% holding) in ABC Ltd (unlisted trading company) on 1 April 1999 for £100,000. On 30 March 2002 he gave them to an interest in possession trust of which he was the life tenant. The shares were worth £140,000 and the gain was held-over.

On 5 April 2011 the trustees sold the shares for £180,000. Neither they nor Paul made any other disposals.

Calculate the CGT payable on the disposal in April 2011.

Answer 1

	£
Gift on 30.3.02:	
Market value	140,000
Less: cost (1.4.99)	(100,000)
Gain	£40,000
Trustees' base cost:	
MV @ gift	140,000
Less: gift relief (s. 165)	(40,000)
Base cost	£100,000

The shares are business assets. Gift relief is available on transfers to settlor interested trusts before 10.12.03.

Gain on 5.4.11:	£
Proceeds	180,000
Less: Cost (30.3.02)	(100,000)
Gain	80,000
Less: AE	(5,050)
Taxable gain	£74,950
CGT @ 28%	£20,986