CHARITABLE REMAINDER TRUSTS: A PROPOSAL

James Kessler QC[1]

Introduction

Charitable giving in the USA (measured by reference to GDP) is more than double that in the UK. In 2002 $184 billion was given by individuals in the USA representing 1.75% of GDP. By contrast, individual giving in the UK was £7 billion representing £0.75% of GDP[2]. There are doubtless many causes for this remarkable disparity. One significant cause is that the USA has more generous tax reliefs for charitable giving, of which the most important is relief for charitable remainder trusts ("CRTs").

There is therefore every reason to introduce a comparable relief in the UK, and the Institute for Philanthropy (amongst others) are lobbying for this reform. On behalf of the Institute I have prepared a proposal for a scheme of tax reliefs for a CRT. This paper sets out that proposal and discusses some of the policy decisions which would need to be made.

I use the term CRT to mean (in short) a trust under which the trust property is held for an individual (or two individuals) for a period, with remainder to charity.

---

1 James Kessler QC, 24 Old Buildings, Lincoln=s Inn, London WC2A 3UP. Tel: (020) 7242 2744. Fax: (020) 7831 8095. E-mail: kessler@kessler.co.uk He is the author of "Venables & Kessler on the Taxation of Charities", Key Haven Publications, 4th ed., 2002. The fifth edition will be published in September 2005.

An earlier version of this paper was presented at the Lifetime Legacies/Charitable Remainder Trusts Summit convened by the Institute for Philanthropy on 24 January 2005. See the report of the Summit which is the subject of a separate article in this issue of the Review.

2 See "Philanthropy in the Twenty First Century", Institute for Philanthropy, *www.instituteforphilanthropy.org.uk/hbwcoutts_final.pdf*.

In this Paper:

(1) The "settlor" means the individual who makes the CRT.

(2) "The life tenant(s)" means the individual(s) who receive(s) the income of the CRT for a period.

Summary of Policy Issues

To be satisfactory to potential donors:

(1) The tax reliefs must be sufficiently generous.

(2) The terms of the CRT must not be too restrictive.

To be satisfactory to the Treasury and the Inland Revenue:

(1) The benefit of the additional sums raised for charity overall must exceed the revenue forgone by the tax reliefs.

(2) The tax reliefs on any single gift should not exceed the value of the benefit to charity. There should not be any incentive to make a gift to a CRT purely to reduce tax (in a manner which improves the position of a settlor who is not actually desirous of benefiting charity.)

(3) There must be protection against avoidance and evasion.

(4) The scheme must be consistent with (and avoid anomalies compared to) the current scheme of UK charity tax reliefs.

Lastly, the administrative costs of setting up, running and supervising the CRT, i.e. expenses of the trustees of the CRT and the costs of the Inland Revenue, must be reasonable.

These considerations conflict and compromises must be made between them.
It is not possible to assess or even discuss CRTs in the abstract because, as so often with tax, the details matter as much as the broader concept. For instance, support for a scheme which allowed income tax relief for gifts of works of art would be quite different from one which did not. Again, the consequences of a scheme where the income tax relief was limited to the income of the individual in any year (i.e. there was no carry forward of surplus relief) would be significantly different from the same scheme if income tax relief could be carried forward.

Again, the operation of inheritance tax (IHT) relief for gifts to a CRT makes an enormous difference to the attraction of the scheme (which helps donors but would concern the Treasury).

The Settlor

I propose the relief should only apply to a CRT made by an individual.[3] There would be no restrictions on residence or domicile of the individual. The aim is to encourage giving by individuals whenever resident or domiciled.[4]

The Charity

The charity may be:

(1) a specified charity, or a number of charities in fixed shares;

(2) such charities as the trustees appoint, or

(3) charitable purposes (i.e., on the expiry of the fixed period, the CRT becomes a wholly charitable trust).

Length of non-charitable period

I consider the following types of CRT:

(1) income paid to the settlor for the period of his or her life, remainder to charity.

(2) income paid to an individual (not the settlor) for life, remainder to charity.

---

3 (1) CRTs made by companies or existing non-charitable trusts raise considerable further complications.

(2) The practical use of CRTs made by companies may be limited, though that depends on what reliefs are available. Practical use of CRTs would sometimes be made by trusts, but not sufficient to justify the complications.

4 This is the same as for the purposes of qualifying investment donation relief (QIDR), the income tax relief for gifts of qualifying investments to charity, and (subject to an immaterial exception) for the purposes of Gift Aid.

(3) income paid to the settlor for life, remainder to another specified[5] individual for his or her life, remainder to charity.

I consider CRTs made by lifetime gift and by Will.[6]

Other Non-Charitable Periods?

Thus the non-charitable period (the period during which income is paid to individuals) is the length of one or two lives. There are other possible non charitable periods:

(1) the shorter of the life tenant's life and a fixed number of years, e.g., 20 years.

(2) the longer of the life of the life tenant and a fixed number of years.

(3) a fixed period of years, say, 20 years, irrespective of the life of the life tenant.

However, I do not see much need for these periods.[7]

Type of Income Interest during Non-Charitable Period

The possibilities are as follows:

(1) the individual enjoys the use of property (ie the property is enjoyed in kind). The individual would be liable for insurance and maintenance costs.

---

5 Specified by name. One could not allow a gift to a CRT to the settlor for life, remainder to the settlor's "widow" because the possibility that the settlor might remarry a younger spouse makes a valuation of the charity's reversionary interest impossible.

6 CRTs of type (1) and (3) assume the settlor is alive, but CRT type (2) can be made by lifetime gift or by will.

7 Possibility (1) may be suitable to provide an income to tide an individual over until a pension begins (at pensionable age) or until the individual's outgoings reduce (e.g., children leave full time education). Possibility (2) provides an element of "insurance" against the loss to the individual by an early death. However these will not often be useful. We need to balance the advantage of flexibility against the additional complexity raised by having these different types of CRT. Unless there is evidence of need from charities or potential donors, it seems best to limit the CRT to simple life interests as set out above.

(2) the individual receives the actual trust income[8] computed on ordinary trust law principles ("an ordinary income interest").

(3) the individual receives an annual (or monthly) sum which may be:

(a) a fixed sum[9] or a fixed sum linked to the retail prices index.

(b) (perhaps[10]) a fixed percentage of the market value of the trust fund computed on an annual valuation day.

I refer to these together as "annuities".

It is likely that potential donors would sometimes prefer an ordinary income interest and sometimes annuities, so the CRT regime should offer both.[11]

The amount of the annuity would be set at an amount comparable to normal income yields so there would not be much surplus income. That would simplify the valuation process.

If the amount of the annuity paid in any year is less than the trust income (computed on ordinary principles), surplus income would be accumulated[12] or paid to charity. If the amount of the income is not enough to pay the annuity, the shortfall would be paid out of capital. In practice there should not be much of a shortfall or surplus.

8 Less expenses properly payable out of income.

9 This can of course be expressed as a fixed percentage of the initial value of the trust fund, say, 4%.

10 If there is evidence of need for this option from charities and donors. It is used in the USA but not found in the UK. The position could be simplified by not offering this option. This option assumes that the trust fund consists only of assets which have a market value which can easily be ascertained. In practice it would be restricted to investments quoted on a recognised stock exchange.

11 An attraction of annuities from the viewpoint of life tenants (and regulators) is that the amount paid is fixed. In the case of the ordinary income interest I have considered whether there is scope for abuse by manipulating the amount of trust income. In practice the steps considered below would prevent this.

12 (So long as the law allows) which during the life of the settlor, or 21 years from the date of the CRT, in the case of an English or Scottish trust. (There are proposals to change the law on this point but the timescale is very uncertain.) There is no restriction in Northern Ireland.

Alternative: High yield and low yield annuities

It would be possible to allow the fixed amount to be more than a market rate of return (I refer to this as a high yield annuity). However, some difficulties then arise:

(1) (unless the life expectancy is short) the charity would not receive much, if anything, as the capital would be eroded in order to pay it. Thus this could only be done with very elderly life tenants.

(2) this option may reduce the benefits to charity. There is some risk that you would otherwise have taken a normal annuity and may prefer to take a high yield annuity, so the charity overall would lose out.

(3) the income tax (IT) treatment of the annuity would need further consideration.

(4) a capital gains tax (CGT) exemption for the CRT (which is proposed below) would not be justified in such a case.

It would be possible to allow the fixed amount to be *less* than a market return.

For example, a donor may want to give £1m to a CRT and only seek a rate of 1% on the capital given. There can be no objection as long as the CRT's surplus income was paid to charity. But the donor could achieve the same result by making two gifts, a smaller gift to a CRT and an outright gift to charity.

It seems better not to do this. This could be reviewed if there is evidence from charities or donors of a need for annuities at less than or more than normal income yields.

IHT Relief on gift to CRT

I identify three kinds of CRT:

(1) income paid to the settlor for the period of his or her life, remainder to charity.

(2) income paid to an individual (not the settlor) for life, remainder to charity.

(3) income paid to the settlor for life, remainder to another individual ("the reversionary life tenant") for his or her life, remainder to charity.

These raise different IHT issues.

Income paid to the settlor for the period of his or her life, remainder to charity.

If the settlor is the life tenant, the IHT position under current law is as follows:

(1) there is no IHT on the gift.[13]

(2) there is also no IHT on the death of the settlor (as the IHT charity exemption will apply).

Accordingly, in this situation, there is no need for any CRT IHT relief.

Income paid to an individual (not the settlor) for life, remainder to charity

If another individual is entitled to the income, the IHT position under current law would be as follows:

(1) the gift to the CRT is a transfer of value.

   (a) The value transferred is normally the market value of the asset given to the CRT).

   (b) (i) In the case of a lifetime gift to a CRT the transfer of value is in principle[14] a potentially exempt transfer (PET). (That is, it becomes chargeable and subject to IHT if the settlor dies within seven years.)

---

13 Section 49 IHTA 1984.

14 In many cases an IHT exemption will apply:

   (1) where the other individual is a dependant relative, as defined, dependant relative relief will usually apply on a lifetime gift: section 11 IHTA 1984.

   (2) where the life tenant is the spouse of the settlor, the IHT spouse exemption will usually apply.

   The 2005 Budget announced that the IHT spouse exemption will be extended to apply to civil partners under the Civil Partnership Act 2004 (see Clause 103 of the Finance (No. 2) Bill 2005). The comments in this paper about spouses will apply equally to civil partners.

(ii) in the case of a gift to a CRT by Will, the transfer of value is in principle a chargeable transfer and subject to IHT.

(2) there is no IHT charge on the death of the life tenant, as the IHT charity exemption will apply.

I propose there should be a CRT IHT relief so that the gift to the CRT is not a transfer of value. This relief should apply both to lifetime gifts to a CRT and to gifts to a CRT by Will. It follows that no IHT will be charged on the death of the settlor. In the case of gifts by Will, and lifetime gifts by a settlor with life expectancy of less than 7 years, this is a valuable relief. In other cases, it is not such a valuable relief as the gift to the CRT is likely not to become chargeable (or it would be cheap to insure against the risk of IHT.)

An alternative?

An alternative is that there should be an IHT relief which reduces the amount of the value transferred on the gift to the CRT down to the value of the life tenant's interest at the time of the gift. This seems logical since the gift to the CRT does effectively transfer the rest of the value to charity. The objection to this is that:

(1) the IHT charge is borne by the capital of the trust fund, and so would, to a large extent, be effectively borne by the charity. The object of CRT relief is to avoid this.

(2) the IHT charge would have to be taken into account in valuing the gift to the charity, which would greatly complicate the valuation.[15]

(3) another difficulty (in the case of a lifetime gift to a CRT) is the uncertainty which it would bring, as the premature death of the settlor by some unfortunate accident would give rise to a very substantial IHT charge.

It would not be satisfactory if there were no IHT relief at all. A well advised elderly donor (i.e. one whose life cannot easily be insured against the risk of death within 7 years) would never make a gift to a CRT. He would, if he could, make two separate gifts:

(1) a gift of some capital to the individual who would have been the life tenant under a CRT[16], and

---

15 The liability would depend (*inter alia*) on gifts made by the settlor within 7 years before the gift to the CRT.

(2) a gift of some capital to charity.

In that case the gift to the charity would qualify for the current IT and IHT charity reliefs. One object of the CRT scheme should be to make these complications unnecessary.

Income paid to the settlor for life, remainder to another individual for his or her life, remainder to charity.

This leaves the question of the IHT treatment on a gift to a CRT where the income is paid to the settlor for his life, remainder to another individual ("the reversionary life tenant") for his or her life, remainder to charity.

The IHT position under current law is as follows:

(1) there is no IHT on the gift to the CRT.

(2) there is a chargeable transfer on the death of the settlor.[17]

(3) the value transferred on that chargeable transfer is equal to the value of the trust fund.[18]

I propose this should be dealt with in the same manner and there should be an IHT relief on the death of the settlor. The value of this relief depends on the age of the settlor: if he is relatively young, any tax saving is deferred (and could often be avoided by simple IHT planning.)

An alternative would be to provide some limited relief on IHT on the death of the settlor. This might be that:

(1) the gift to the CRT should constitute a PET.

(2) the value transferred by the PET will be the value of the reversionary life interest at the time of the gift to the CRT.

(3) there will be no IHT charge on the death of the settlor.

---

16 That individual might use the capital given to him to purchase an annuity (which would be treated as a "purchased life annuity" for income tax purposes).

17 Unless the settlor was married to the reversionary life tenant in which case the IHT spouse exemption would normally apply.

18 s.52 IHTA 1984.

The objection is as before: in particular, this IHT is necessarily paid out of capital and so largely borne by the charity.

IHT: anti-avoidance rules

Some of the existing anti-avoidance rules for IHT charity relief are designed specifically in order to prevent IHT relief on a gift to a CRT. They would not be appropriate. Instead these rules would, in principle, be made to apply to the reversionary interest received by the charity. The anti-avoidance rules would be as follows. The charity's reversionary interest must not depend on a condition and must not be defeasible.[19] That interest must not become applicable for non-charitable purposes.[20] The related property rules[21] and s. 41 IHTA 1984 (burden of IHT) would apply to a CRT just as they apply on a gift to a charity.[22]

In the annuity CRTs the individual should be treated as if he had an interest in possession in the entire CRT for IHT purposes.[23]

Income tax relief on gift to CRT

The incentive to make a lifetime gift to a CRT will normally be IT relief[24] on the gift.

At present, IT reliefs only apply to a gift to charity of:

(1) money;

---

19 See section 23(2) IHTA 1984.

20 See section 23(5) IHTA 1984.

21 See s.161(2)(b) IHTA 1984.

22 The possible application of section 29A IHTA 1984 is another detail. The simple course would be to apply the section. However, s.29A is by no means easy to understand and ideally should be subject to review itself.

23 This would be more or less the position anyway under section 50(2) IHTA 1984: but to the extent (if any) that section 50(2) did not give the individual an interest in possession, I suggest that he should be regarded as having an interest in possession for IHT purposes. This avoids the possibility of a charge under s. 70 IHTA 1984.

24 I refer to this relief as "IT relief" for convenience. The label is, strictly, inaccurate if (as proposed) the relief can also be set against chargeable gains. However I use the term "CGT relief" to refer to the relief against the chargeable gain which would arise on the disposal to a CRT.

(2) qualifying investments;[25]

I propose the same rule should apply to gifts to a CRT.

At present there is no income tax relief for gifts of works of art. The strong case for introducing such relief for pre-eminent chattels is made in the Goodison Report.[26] If Parliament introduces income tax relief for gifts of works of art or other assets, then gifts of such assets to a CRT should equally qualify for IT relief. However, so long as there is no IT relief for outright gifts to charity of works of art or other assets, there is no case for an IT relief on a gift of such assets to a CRT. Otherwise we would have the anomaly that a gift to a CRT qualifies for more relief than an outright gift to charity.

The existing IT relief for gifts to charity are limited to lifetime gifts and do not apply to gifts by Will. I propose that the same rule is applied to CRTs. That is, only a lifetime gift to a CRT will qualify for the IT relief. A gift by Will to a CRT would qualify for the IHT relief as discussed in this Paper, but not IT relief. Otherwise we would likewise have the anomaly that a gift by Will to a CRT qualifies for more relief than an outright gift by Will to charity. (This rule is a rational one as the position of gifts made by will and completed later by executors is not in all points the same as a lifetime gift by an individual.)

The amount of IT relief should be the value given to charity, which is the fraction A ÷ TF where:

A is the value of the charity's reversionary interest.

TF is the market value of the trust fund. [27]

---

25 Defined in section 587B(9) ICTA 1988. These are, in short: listed shares or securities; authorised unit trusts; open ended investment companies; offshore funds; and freehold and leasehold interests in land.

26 "Securing the Best for our Museums: Private Giving and Government Support", HM Treasury, January 2004.

27 An alternative formula is that the relief is A(A + B) where:

A is the market value of the charity's reversionary interest.

B is the market value of the life tenants life interest.

In practice this would give the same result if the approach to valuation in this paper is accepted.

Use of IT relief

In the first instance, IT relief in a year will be set so far as possible against the donor's total income of the same year, like qualifying investment donation relief.[28]

It is suggested that:

(1) any surplus amount of relief should be set against chargeable gains of the settlor in the same year.

(2) surplus relief after that should be carried forward to set against other income and gains for future years.

Setting CRT relief against chargeable gains

At present we have the anomalous situation where:

(1) relief for *Gift Aid* donations by individuals can be set against income and chargeable gains.

(2) relief on *qualifying investment* donations for individuals is set against income but cannot be set against chargeable gains.

(3) companies can set gifts of cash or qualifying investments against both their income and chargeable gains.

My proposal does not add an anomaly, but it sides the new relief with Gift Aid relief. (It would be logical to bring QIDR into line with Gift Aid by allowing QIDR relief to be set against chargeable gains for individuals. This is, strictly, outside the scope of this Paper.)

---

28 An alternative is to gross up the value of the gift and, allow the charity to claim income tax at the basic rate, as is the case for Gift Aid relief. In economic terms it makes little difference as the same result can be achieved with each system. However:

(1) my proposal is simpler to understand;

(2) it does not involve the charity in a valuation exercise, so it is simpler to operate.

(3) it is psychologically more attractive to donors.

(4) the Gift Aid system would not allow a carry forward of surplus relief (which is proposed for CRTs).

Carry forward of CRT relief

The case for allowing a carry forward of CRT relief is very strong. It is essential to allow this if the object is to raise substantial sums for charities. Otherwise no well advised settlor would donate a value larger than the amount of their taxable capacity (i.e. total income and (if allowable) chargeable gains) in any year. The Goodison report also recommended a carry forward for the proposed relief for works of art.

It is not, strictly, logical to allow a carry forward of the CRT relief unless carry forward is also allowed for QIDR. It would be sensible to amend the QIDR rules without a carry forward at the same time. Although that would be an improvement, and a tidier law, the anomaly (if it arises) is not too serious.

Carry back of CRT relief

At present we have the anomalous situation where:

(1) QIDR relief cannot be carried back;

(2) higher rate relief under gift aid can be carried back one tax year (s.98 Finance Act 2002).

Unless it is desired to extend the QIDR relief to allow a carry back it would be consistent not to allow a carry back of CRT relief. I do not think the carry back facility would greatly improve the take-up of QIDR relief. (However this can be reconsidered if here is evidence of need from donors.)

IT relief on gift to CRT: anti-avoidance rules

There have recently been artificial tax avoidance schemes exploiting QIDR, to which the Government have responded with new provisions in the Finance Act 2004. One course would be to put similar provisions in the CRT regime. I do not advocate this because the rules are complex and there are doubts whether they will be effective.

A better alternative would be to provide that the receipt is to be regarded as income of the CRT. If the CRT applies its funds for non-CRT purposes or ceases to be a CRT:

(1) the CRT would then be subject to income tax or corporation tax.

(2) the donor would lose his higher rate relief.[29]

That would be a simpler and a more satisfactory solution.[30]

Benefits for donors

At present we have the anomalous position that:

(1) benefits for donors (above a small level) disqualify a gift from Gift Aid relief.

(2) benefits for donors do not disqualify a gift from QIDR relief, but they reduce the amount of that relief.

I think it would be satisfactory to apply the Gift Aid rule to CRT relief. That is, the donor must not receive any benefit in consequence of his gift to a CRT above a very small limit (of course the retained life interests would not count for this purpose). One attraction of this course is that it reduces the scope for tax saving by selling assets to a CRT at their base cost so as to maximise the benefit of the CGT relief[31]. Given the other reliefs applicable to a CRT, that relief is not called for. However, this can be reconsidered if there is evidence of need from charities and donors.

CGT relief on gift to CRT

The CGT position under current law is that a lifetime gift to a CRT will normally[32] be treated as a market value disposal. The gain arising on that disposal would be subject to CGT.

---

29 A similar rule was formerly found in section 683(4) ICTA 1988.

30 Other rules of QIDR which should also apply to gifts to a CRT are:

(1) the disposal must be of the whole of the donor's beneficial interest: s.587B(1).

(2) rules relating to land held jointly: s.587C (2)(3).

(3) rules preventing double deduction: s.587B (2)(a).

31 For example, if a donor has an asset worth £100 with a CGT base cost of £50 he may sell the asset to the CRT for £50, and, separately, give the £50 to another CRT. That would be better than a gift of the same asset to a CRT for no consideration.

32 Hold-over relief may be available in the case of agricultural and business property.

I propose that there should be a CGT relief on a lifetime gift to a CRT. This would be the same as relief on a gift to charity: the CRT would acquire the asset given on a no gain/no loss basis.[33]

This is in line with the current QIDR regime. While IT relief on the gift will be the main spur to giving to CRTs, CGT relief is essential, otherwise the CGT cost may make gifts to CRTs unattractive.

CGT relief on gift to CRT: anti-avoidance rules

No anti-avoidance provisions will be needed (just as there are none for the CGT relief on gifts to charities). The effective anti-avoidance rule is that CRT takes over the base cost of the settlor.

Tax treatment of Life Tenant

All receipts by the individual life tenant from the CRT would be taxable as his or her income.

In the case of an ordinary income interest, the life tenant would be taxed like any life tenant. He or she will be regarded as receiving the income of the underlying assets of the trust fund and will have the benefit of any tax credits.

The issue of the taxation of an annuity paid to a life tenant from annuity CRTs will probably be answered from 2006/7 by the proposal for "income streaming".[34] Income will be taxed as if the life tenant receives the underlying income.

It might happen that the amount of income paid to a beneficiary under an annuity exceeds the amount of trust income. I propose that the surplus would be charged to income tax[35]. Unless high yield annuities are permitted, there would not in practice be much income in this category.

---

33 See section 257 TCGA 1992.

34 See section 3 of "Modernising the tax system for trusts": a consultation document, Inland Revenue, August 2004.

35 It could be dealt with under the deduction at source rules of section 348 ICTA 1988, but it would be simpler simply to tax it as income in the hands of the life tenant.
If high yield annuities are to be permitted this may need to be reviewed.

The beneficial use of property in kind[36] under a CRT would not be taxed. This is the position under the current law.

Tax treatment of Trustees of CRT

Income received by CRT

I propose that income received by the CRT and paid on to the life tenant will be taxed as income of the life tenant just like any interest in possession trust.

Undistributed income

Income may be received by the CRT and not paid on to the life tenant in two circumstances:

(1) it may be used for administrative expenses.

(2) it may be that the actual income of the trust fund (computed on ordinary trust principles) exceeds the amount of the annuity due to the life tenant under the annuity types of CRT in which case the surplus income may be:

(a) accumulated; or

(b) paid to the charity.

I refer to this for convenience as "undistributed income" (i.e. not distributed to the life tenant).

I suggest that undistributed income should receive the same exemption as income accruing to charities. Tax credits would not be re-claimed but there would be no further tax charge.[37]

The tax treatment of undistributed income is not a matter of much importance because (under my proposals) the amounts involved would not in practice be substantial.

---

36 The pre-owned asset rules in Schedule 15 FA 2004 would be disapplied for a CRT.

37 For completeness, this would not apply to income of the kinds for which charity would not have any exemption (e.g., trading income). Otherwise we would have the anomaly that a CRT would enjoy better tax relief than a charity. In practice a CRT would not receive such income.

Chargeable gains accruing to CRT

I propose chargeable gains accruing to a CRT should receive the same exemption as gains accruing to charities.

It may be objected that this is too generous since it would allow CGT-free accumulation of funds. However:

(1) the advantages of this relief will accrue in due course to the charity: all assets distributed to a life tenant are taxed.

(2) this is no better than comparable investment vehicles: authorised unit trusts and investment companies qualify for similar exemption.

The alternative is that gains (and any undistributed income) would be subject to tax at the basic[38] rate (unless paid to charity).

CRT income and gains: anti-avoidance

The anti-avoidance provision relating to income and gains of charities would apply.[39]

Excessive CGT benefits?

This proposal is, arguably, too generous where:

(1) substantial gains accrue on the gift to the CRT; and

(2) the value of the life interest(s) is most of the value of the trust fund (because the life tenant(s) is (or are) relatively young).

---

38 Not at the rate applicable to trusts 40%, section 686 ICTA 1988. That would be a serious disincentive to giving to a CRT.

39 This requires (in short) that all the income and gains are applied for charitable purposes. For the purpose of applying these rules to a CRT, of course, the rule would be that income and gains of the CRT must be applied for the purposes of the CRT. See section 506 and Schedule 20 ICTA 1988.

In the case of CRTs where the settlor has a life interest, section 660A ICTA 1988 and section 77 TCGA 1992 (which would tax the settlor on undistributed income and on trust gains) would be disapplied.

In an extreme[40] case, suppose a settlor holds an asset worth £100 with no base cost. If he sells it he is left with £60 after CGT. If he gives it to a CRT, for himself for life with remainder to a charity the benefit to charity may be £25 and the CRT saving £40. However, the actual value of the interest retained by the settlor will be the value of a life interest, which is a less convenient asset. In other words, most settlors would rather pay the tax than make a gift to the CRT. If this nevertheless is perceived to be a problem, the solution would be to restrict the CGT relief on a gift to a CRT up to a cap being the value of the benefit to the charity (as computed for IT relief). Thus nobody would ever save CGT by making a gift to a charity which qualifies for CGT relief. On the facts of the above example, CGT relief is limited to £25. In practice this cap would not normally be a problem for potential donors. However I doubt if this complication is necessary.

Basis of valuation of interests

The reversionary interest of the charity under the CRT must be valued to ascertain the amount of IT relief.

I suggest that interest should be valued on the (fictional) basis that one should assume that the life tenant has a normal life expectancy. [41] The advantage of this is that valuation can be made a straightforward exercise based on some published actuarial table. It would depend only on:

(1) the age and sex[42] of the life tenant(s);

40 This will not in practice happen very much if at all. Because of CGT taper relief, and because the asset will usually have some base cost.

41 If the valuation depends on the actual state of health of the life tenant, then medical evidence and examination would be necessary. That would add significantly to the administrative costs. To prevent possible abuse, the Revenue may need to make an independent medical examination; this would not be acceptable to settlors or life tenants. This route disadvantages the settlor (and favours the Revenue) if a life tenant is in poor health for his or her age. Suppose, for instance, a 50 year old just has a few years life expectancy. The actual value of the gift to a CRT (for that individual for life remainder to charity) would be a large part of the value of the fund given. On my proposed basis of valuation, however, the value (and hence the relief) would be much less. Nevertheless, I think this course is the lesser of two evils. In practice the problem would not often arise.

42 Gender is relevant because it affects life expectancy. One could, of course, ignore this factor if desired.

(2) the value of the capital given to the CRT.[43]

The valuation would be on the basis that the interests of the life tenant(s) and charity together amount to 100% of the trust fund. That is, there will be no discount in valuing the interests separately, i.e. no “marriage value”. This is, in practice, important. Although a very limited market for life interest and reversionary interests exists it is not active enough for one to be confident about what the market value of any particular interest at any particular time would be, if valued separately.

Minimum Charity Benefit

Following the US example, I propose that there should be a minimum benefit to charity. The value of the charity’s reversionary interest should exceed a percentage of the trust fund.[44]

The precise level chosen must, to some extent, be an arbitrary decision. In America the minimum level is 10% of the trust fund, and 10% has recently been proposed for the new gift aid rules concerning admission to premises (see clause 31, Finance Bill 2005). I tentatively suggest a 25% minimum limit as a general rule.

A 40% minimum limit would not be satisfactory. On this aspect, Brian Watson of Foster and Cranfield (actuaries) has kindly supplied *pro bono* actuarial advice which is set out in the Appendix. It shows that:

(1) a 25% limit would not be a major restriction on giving to CRTs as in most cases the ages of the likely life tenant(s) will be such that the 25% test will comfortably be met.

(2) the 40% limit may discourage gifts to a CRT.

To what extent this rule might lead to CRTs being used to obtain the tax advantages in circumstances where the tax advantage is much greater than the benefit to charity? For instance, a testator contemplating a 40% IHT charge on

---

43 The QIDR valuation rules would apply. (A complication is if the donor gives a lease of land to a CRT as that is a wasting asset. That would need to be taken into account in the valuation.)

44 There might be an additional requirement that the benefit to charity must exceed a fixed amount, but this is not necessary as in practice small gifts would not justify the administrative costs and would not be made.

gifts to relatively young children or (actuarially more likely) grandchildren may say: "rather than making a gift to my grandchild absolutely (subject to IHT) I will make a gift to a CRT giving him a life interest". If the child is a male between 31 and 48, the charity's reversionary interest is worth between 25% and 40% of the fund, but the IHT saving is 40%.

In practice IHT planning of this kind is not likely to be attractive. The reason is that the actual value of the interest received by the grandchild (the life interest) is (on a true market valuation) discounted to allow for the fact that it is a life interest. In other words, if a grandchild would rather have (and a parent would rather give) an outright gift subject to IHT than a life interest IHT free.

Any scheme which links the minimum charity benefit more accurately to the IHT benefit becomes impractically complicated.

Trust law aspects

We need to ensure the rules concerning the creation and supervision of CRTs are such that the value in the charity's reversionary interest remains preserved for the charity and is not in any way made available to the life tenant(s) or any other non-charity.

A CRT is not a charity for the purposes of charity law and will be outside the jurisdiction of the Charity Commission (or its equivalent in Scotland or Northern Ireland). They could be given jurisdiction but this should not be necessary.

If a specific charity is the reversionary beneficiary under a CRT, that charity has a financial interest in ensuring proper administration of the CRT. However, it is proposed that a settlor should be able to create a CRT where:

(1) he has a power to appoint the funds to any charity, or

(2) where the CRT itself becomes a charity,

In these cases there is no identifiable charity with a financial interest in supervising the CRT.

It is suggested that the following rules should prevent evasion in practice:

(1) the CRT should be within the jurisdiction of a UK court: this can be met by requiring a UK proper law (i.e. English, Scottish or Northern Ireland law).

(2) the trust deed:

(a) does not restrict liability for breaches of trust.[45]

(b) does not relax the usual duty on trustees to find a fair balance between the interests of life tenant and remainderman. It should expressly exclude the current rule that in exceptional circumstances (such as poverty) the trustees may to some extent favour the life tenant over the remainderman.[46]

(c) does not affect the self dealing rule for trustees.

(3) the trustees must include a person who is UK resident, not disqualified from acting as a charity trustee[47], and who is:

(a) a professional trustee (i.e. a solicitor, accountant or barrister) with a practising certificate; or

(b) a trust corporation (adopting the Trustee Act 1925 definition, which requires a substantial company with a minimum of £250,000 capital);[48] or

(c) if there is a specified charity remainder beneficiary not connected[49] to the settlor,

(i) that charity or

(ii) a person nominated by that charity who is not the settlor or life tenant or connected to them; or

---

45 For a precedent see Pensions Act 1995 section 33, which excludes such clauses for pension schemes. The Law Commission have proposed restrictions on the operation of trustee exemption clauses but it is, at present, unclear what proposals will be taken forward (see "Trustee Exemption Clauses" (Consultation Paper) [2003] EWLC 171, 1 May 2003, www.bailii.org/ew/other/EWLC/2003).

46 See *Nestlé v National Westminster Bank* [1993] 1 WLR 1260.

47 Thus incorporating by reference the rules in s.72 Charities Act 1993.

48 A definition of "trust corporation" would be needed for Scotland, as Scots trust law does not use this term.

49 The definition of "connected" needs thought but that is a point of detail which need not be decided at this stage.

(d) a trustee approved by the Revenue.

(4) a charity with a fixed interest must be informed of its interest under the CRT.

(5) the terms of the CRT must provide[50] that its income and gains cannot be used for any purpose other than CRT purposes.

(6) in the event of a breach of trust, there will be a clawback of the CRT tax reliefs to the extent that funds are lost to the CRT. If the trust ceases to be a CRT, there will be a clawback of the CRT reliefs.[51]

(7) CRTs must prepare accounts to the similar requirements as charities (ie larger CRTs must have audited accounts; smaller ones must have accounts examined by an independent examiner.)

The Revenue would prepare sample precedents for CRTs.[52] This would save administrative time and expense both for taxpayers and for the Revenue.

An alternative for annuity CRTs

An alternative for annuity type CRTs is that the funds pass to the charity absolutely, and the charity has a personal obligation to pay the annuity.

This would lead to considerable administrative savings. The financial security of the life tenants would be reduced as they would merely have unsecured contractual rights against the charity and would lose if the charity became insolvent. However, in practice they may be prepared to accept that.

The difficulty would be the law of investment protection. If the charity were carrying on life insurance business, it would need to be regulated. This problem would make the proposal impractical.

It should, however, be possible to merge annuity CRTs (and in principle ordinary income CRTs) so that one set of trustees may manage substantial funds for the

50 Modelled on section 660A ICTA 1988.

51 This will prevent a charity selling its reversionary interest to a non-charity, which might in some cases give rise to abuse.

52 Or approve standard forms prepared by others, perhaps the Charity Law Association or the Charity Commission.

benefit of a variety of annuitants. No doubt bodies like the CAF which offer charity trustee services would offer this service. That might give rise to administrative savings.

Further anti-avoidance provisions?

I see no practical difficulty in a further "all purpose" anti-avoidance provision excluding CRT relief if where one of the purposes of the gift to the CRT is the avoidance of tax. However, that should not strictly be necessary.

If further complex anti-avoidance provisions are to be considered, it is very important that they should be fully discussed with charities. It is possible for over-rigorous anti-avoidance provisions to make what an otherwise sensible relief extremely difficult to operate or unworkable (relief for enterprise investment schemes may serve as an example).

Conclusion

The idea of a CRT is simple. The complexity of this paper may surprise some readers and appal those unfamiliar with the UK tax system. But if a CRT is to fit into our highly complex tax system it cannot be altogether simple. What this paper does demonstrate, I hope, is that the American style CRT is attainable in the UK, though a great deal of thought needs to be given to its design.

APPENDIX: ACTUARIAL EVIDENCE

Although a very limited market for trust interests exists (e.g. Foster & Cranfield's periodic auctions) it is not active enough for one to be confident about what the market value of a particular interest at a particular time would be; I noted when we spoke that this does not prevent the Inland Revenue (Capital Taxes) insisting on hypothetical market values for financial interests in some circumstances. We agreed that the best approach was to value the interests as if we were advising on an agreed partition of a trust.

The usual (but not the only) actuarial approach, and the one which I use, to an agreed partition means that the sum of the values of the life interest and the reversionary interest is equal to 100% of the trust value (i.e. there is no marriage value). If the remainderman was not a charity the value of the reversionary interest would often include prospective IHT.

The key assumptions are the appropriate mortality table and the yield on the trust's assets. In what follows I have used an up to date mortality table that covers the population of the UK and have assumed investment in a spread of mainly UK equities and bonds providing an income of 3.2% per annum to a basic rate tax payer. Clearly both of the mortality and yield assumption are open to debate. I have assumed the life tenant is in normal health for someone of their age.

For a single male life tenant the ages at which the value of the charity's reversionary interest is respectively 10%, 25% and 40% are 1, 31 and 48.

For a single female life tenant the ages at which the value of the charity's reversionary interest is respectively 10%, 25% and 40% are 5, 36 and 52.

I have also looked at the case where a husband and wife are the life tenants and the income continues until the death of the survivor. I have made the assumption that the wife is 4 years younger than the husband. My calculation was a bit more approximate than the one for a single life tenant. For husband and wife life tenants (where the wife is 4 years younger than her husband) the husband's ages at which the value of the charity's reversionary interest is respectively 10%, 25% and 40% are 5(!), 44 and 60.

Brian Watson
Fellow of the Institute of Actuaries
for and on behalf of Foster & Cranfield