

DISCRETIONARY VERSUS INTEREST IN POSSESSION TRUSTS

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Discretionary trusts can in certain circumstances have significant advantages over, say, an interest in possession trust, particularly as to capital gains tax hold-over relief for investment assets under Taxation of Chargeable Gains Act 1992 (TCGA) s.260. It is important therefore to prevent a trap from arising, whereby an interest in possession has in fact been created unintentionally instead of a discretionary trust.

Take two instances:

The Second Home and Other Investments: IHT and CGT

A particular use for discretionary trusts and CGT could be as to second homes following the hold-over conditions and restrictions in TCGA ss.165 & 260. Consider the following steps:

- Father [and mother] transfer a second home into two discretionary trusts in respect of which the son is a potential beneficiary. CGT hold-over relief is available and hopefully no IHT is payable because of one [or two] nil rate bands.
- the trustees allow/entitle son to occupy this home as his main residence.
- subsequently on a sale by the trustees CGT main residence exemption should be available under TCGA s.225, and see *Sansom v Peay* [1976] STC 494. Alternatively, if the trustees advance house to the son, and *he* sells, CGT exemption applies under TCGA s.222.

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During the 36 months preceding a disposal of the home, the main residence exemption can still apply even though not occupied during that period (TCGA s.223(2)).

Consider adapting this method of interposing a discretionary trust for other investments, e.g. quoted shares. For example: discretionary trustees distribute investments to, say, six beneficiaries. The trustees elect for CGT hold-over under TCGA s.260. The trustees are operating within the nil rate band, therefore no IHT is payable and the six beneficiaries may each have his/her CGT annual allowance of £6,800 available for 1998/1999, a saving of up to £16,320.

The trap referred to could be that the discretionary trustees virtually *immediately* on the creation of the trust resolve that the intended beneficiary be entitled to occupy the property as his main residence. Following the decision of *Sansom v Peay* (as above) and the Revenue Press Release 15th August 1979, SP10 1979, that situation would have the effect of making the beneficiary's interest not that of a discretionary beneficiary but an interest in possession. That in turn would mean that the CGT hold-over on transferring the property into the trust would be unavailable it not being a business asset: see TCGA s.165. Contrast the position under TCGA s.260: on gifts into discretionary trusts on which inheritance tax is chargeable, hold-over relief for investment type assets is available.

The proposal is, therefore, to ensure that the discretionary regime does apply for a significant period of time, say 3 - 6 months, and preferably straddling a tax year end, before the chosen beneficiary does become entitled to occupy. Meanwhile, a revocable licence might be granted; and ideally the discretionary trust fund would include some other assets, e.g. cash or shares, where income would be received by the discretionary trustees and distributed in their discretion to one or more of the other beneficiaries.

Similarly, in the case of creating discretionary trusts for other investment assets, the discretionary trust regime needs to subsist for a realistic period, the assets not being distributed to the beneficiaries too quickly.

The second instance involves the use of a flexible discretionary trust arrangement with CGT and IHT mitigation in mind. The background of this suggestion can be summarised briefly as follows:

In order to deal with the investment type assets ("the assets") pregnant with capital gain, where it is not possible to hold-over the CGT under TCGA s.165 (i.e. not business assets), it is suggested that a flexible discretionary type trust be used. This discretionary trust would, after a minimum of three months, terminate initially onto

interest in possession trusts for the client settlor ("the settlor") and then subsequently a further interest in possession or accumulation and maintenance trust for, say, his children or grandchildren from which he and his spouse would be excluded. Within this period there would be a time during which the settlor could claim back the trust fund or a part. The settlor's retained interests are, it is claimed, so substantial that there is little loss to his estate for IHT purposes. It would, therefore, be an appropriate way of channelling assets to the children, minimising the payment of CGT and IHT.

Here again, the use of a discretionary trust for CGT hold-over purposes is an essential element. Moreover, the discretionary trust regime must last for at least 3 months before the variation into the settlor's interest in possession because in those first 3 months there is no IHT payable (IHTA 1984 s.65(4)); and that liability to IHT is an essential requirement of the TCGA s.260 hold-over.

This particular arrangement requires the client to receive a health/wealth warning because the Capital Taxes Office (led by Mr Twiddy) are currently attacking this arrangement; although leading specialists, including Kevin Prosser QC of Pump Court Chambers, remain protagonists. It is likely that that proposal will be tested in the relatively near future.

In other circumstances, the reverse may apply, namely when an interest in possession will be preferable to a discretionary trust. Examples include claiming business assets for the new taper relief, where an investment in a discretionary trust needs at least a 25% shareholding, whereas for interest in possession trusts, where the life tenant is a full time working officer or employee, only a 5% holding is necessary. Another example is in relation to the home left on the death of, say, the husband. The CTO are currently attacking arrangements whereby a widow remains in occupation by virtue of being a discretionary trust beneficiary, it being claimed that the possession constitutes an interest in possession. This attack may even be mounted if the widow is not even a beneficiary but is just bound to occupy by the action or inaction of the trustees. Contrast this with where the husband leaves a revocable life interest in the home which is subsequently divided with other beneficiaries on partial revocation of such life interest.

An interest in possession trust is also particularly appropriate in the period up to 5th April 1999 to trigger the maximum retirement relief pending the gradual withdrawal of this relief under FA1998 s.140, the principal beneficiary being the settlor. This prevents any IHT charge arising, which would not be the case for a discretionary trust.

The Anglo Saxon system of law has a wide and rich selection of trusts to choose from; it is "merely" a question of making the correct choice.