DISCRETIONARY TRUSTS - SELECTED TAX PLANNING SUGGESTIONS

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(All statutory references in this article are to IHTA 1984 unless otherwise stated)

"Discretionary" as the word implies gives rise to wide scope in tax planning. Some instances are analysed below.

IHT - the 10 Year Bonanza

As regards the 10 year anniversary charge for discretionary trusts, the IHT rate continues throughout the period up to shortly before the first or next 10 year anniversary. This gives rise to tremendous opportunities for IHT planning. Take a striking example:

- Mr Discreet creates a discretionary trust on 1st July 1992 valued at £150,000 (the then nil rate band). He appoints Messrs Shrewd and Careful the trustees.

- On 1st June 2002 the trust fund is worth £150 million and Messrs Shrewd and Careful appoint the trust fund to Mr Discreet's two children absolutely; or (probably preferably for CGT and other purposes) appoint the trust fund on flexible interest in possession trusts for those children. No IHT is payable because the original nil rate applies until midnight of 30th June 2002, when the trust fund has to be revalued and IHT (normally at 6%) paid if not previously distributed or resettled as above.

  Awareness of this timing aspect is clearly of vital importance.

  Unfortunately pre CTT trusts i.e. created pre 27th March 1974, do not benefit from this historical valuation, but the distribution charge is based on the market value at that time (s.68(6)).

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IHT 100% Business Property/Agricultural Property Relief and Discretionary Trusts IHTA ss.103-124

The transfer of business assets into such flexible trusts during lifetime or by will should undoubtedly prove among the best estate planning methods available. In particular:

- Most business and agricultural assets will be able to be held in such trusts indefinitely with 100% relief and will not be chargeable at the 10 year anniversary dates nor any interim charges after the first 10 year anniversary charge. At the 10 year anniversary, the trustees will need to satisfy the relevant business or agricultural property conditions. Assuming the 100% relief applies (and any other assets in the trust are within the nil rate band), the 10 year anniversary charge rate will be ZERO, and that zero rate will apply until immediately prior to the next 10 year anniversary, even though the assets are no longer business or agricultural assets, e.g. the trust fund consists of the proceeds of sale.

  An existing trap for the unwary remains relevant for the 50% but not the 100% relief. Under IHTA 1984 s.68(4) and (5) in arriving at the rate of interim charges before the first 10 year anniversary (but not otherwise) no allowance is made for any business or agricultural relief at the 50% rate. As to the 100% relief, the risk has disappeared because the value of the asset for s.68 purposes is ZERO, and therefore there is no charge e.g. under s.65.

- For lifetime discretionary trusts, there is no CGT holdover relief restriction in connection with non-business assets - see Taxation of Chargeable Gains Act 1992 s.260 (there may, of course be an IHT restriction in respect of “excepted” assets - IHTA 1984 s.112).

Example:

A discretionary trust has a 10 year anniversary charge on 31st October 1996 when its trust fund consists of £200,000 (the then nil rate band) in cash and 30% of the ordinary share capital of Trading Co Ltd worth £1 million and a farm owned and managed by the trustees worth £500,000.

Any distribution of the trust fund in whole or part at any time before the next 10 year anniversary will be in effect free of IHT, because under IHTA 1984 ss.68 and 69 the rate at the 10 year anniversary on 31st October 1996 is zero and that zero rate franks, i.e. applies until midnight of 30th October 2006. (But beware of possible change of law by the Labour Government).

Nor is this beneficial treatment affected or altered if after 31st October 1996 the business property or agricultural property is sold or otherwise disposed of (the claw-back provisions in ss.113A & B, and 124A & B are inapplicable, they could only apply if the settlor dies within 7 years of creating the trust).

Indeed the trustees should consider varying the trust so that one or more of the beneficiaries receive a life interest in the trust fund, because in that case on the death of the life tenant there would normally be a CGT exemption and market value uplift and no IHT if the conditions of ss.104, 105, 113 A&B and 116 continue to apply. Note, however, that the life tenant would have to satisfy the time period requirements, e.g. two years for the business property relief. IHTA ss.106 & 117(a).

Investments

- Father and mother (or other donor) could transfer investments into discretionary trusts for their children and/or other selected beneficiaries. CGT holdover relief is available (TCGA s.260) and hopefully no IHT would be payable because one or two nil rate bands would be used. As regards the use of the *second home* in this context see the author's article in PTPR Vol 4, 1995/96, Issue 2, p 122.

The discretionary trustees could after a decent interval of time transfer out the investments to say six beneficiaries. The trustees would elect for CGT holdover relief under TCGA s.260. Trustees operating within the nil rate band would incur no IHT and the six beneficiaries may each have his/her CGT annual allowance of £7,200 available for 2000-2001 - a saving of up to £17,200.

IHT Mini Discretionary Will Trust of the Nil Rate Band

Discretionary trusts can also be used to enable a surviving spouse to enjoy the benefit of a fund without the penalty of wasting the nil rate band. Under this method a discretionary trust of the nil rate band could be used, the distributions from which to the surviving spouse would only be used in cases of need.

For example, assume that husband and wife each have an estate of £500,000; and that the husband dies first wishing his widow to be the primary beneficiary.

Under a commonly used, but wasteful alternative the husband could give his widow his £500,000 estate (absolutely or by way of life interest) ensuring that no IHT was payable on his death. On her death, however, having regard to the bunching effect, other things being equal, IHT would be payable on an estate of £1 million (IHT £306,400 for 2000-2001). A more sophisticated alternative would be for the husband to give his widow only £266,000 and settle the remaining £234,000 (the 2000-2001 nil rate band) on discretionary trusts, with informal directions to the trustees to treat the widow as the principal beneficiary. So, if she was in need, she could have a capital distribution or, perhaps, more appropriately, a loan, which should be a deduction from her estate on her death (but watch FA 1986 s.103 - especially if there have been lifetime gifts from her to her husband); or she could receive income distributions. In that case the IHT at 2000-2001 rates would be reduced to £212, 800 (i.e. on the widow's estate of £766,000) and with the discretionary trust fund constituting a nil rate band. There would be an IHT saving under this alternative of £93,600 (£306,400 - £212,800).

This is regarded as one of the most effective - yet simple - IHT savings that can be introduced in a will. Moreover, as the use of variations may become restricted that saving of £93,600 by use of the mini-discretionary trust would no longer be a mere alternative to doing a variation!! Note also that the use of s.144 discretionary trusts may become short lived.

There are, however, seven possible danger areas to be borne in mind:-

(i) Related settlements (s.62). The value of the other property settled by the will (i.e. the related settlement(s)) could form part of the cumulative total of transfers to which the discretionary will trust takes subject. Likely solution use of “pilot” lifetime trust.

(ii) If the discretionary trust continues for more than 10 years, the IHT 10 year anniversary and interim charges may accrue (ss.64 - 69).

(iii) CGT distributions out of the trust would not be as legatee with the relief afforded under TCGA s.62(4) instead a distribution as trustees.

(iv) IHT distributions to widow(er) within 3 months (s.65(4)). See *Frankland v IRC* [1996] STC 735 and *Loveday decd v CIR* (1997) STC (SCD)321.

(v) No CGT holdover relief in the 2 year period from death.

(vi) No CGT uplift on death of beneficiary. Contrast position if a beneficiary had been given the asset absolutely and died owning it (but subject to IHT).

(vii) From 6th April 1999 discretionary trusts will pay income tax at up to 43% on dividends, e.g. on quoted shares. This results from the abolition of the tax credit when trustees distribute to beneficiaries with this additional tax based on their rates.

A Post Spring Budget 2000 Hedge (Using Multiple Discretionary Trusts to Maximize the Nil Rate Bands - Taken at £234,000) and Pending Possible Changes of Law Made Under Labour

The arrangement can be adopted where 100% BPR/APR applies:

- Assume such business/agricultural assets are worth £1,404,000
- The estate owner creates 6 discretionary trusts, on somewhat differing terms, at staggered intervals each including £231,000 of such assets
- Nil IHT liability on the transfer into the trusts (the 100% relief applies); and CGT can be held over
- Each trust should be protected by the nil rate band rule even if the 100% BPR/APR rules are altered in the future; and even if the assets cease to be BPR/APR assets
- However, the *Ramsay*/associated operations risk remains
- Consider possible loss of CGT retirement relief under TCGA 1992 s.163 in Schedule 6, i.e. there can be availability of retirement and rollover reliefs for trust property with reference to the circumstances of a beneficiary with interest in possession but not a discretionary trust.

  Retirement relief is in any event being phased out over a period from 6th April 1999 to 6th April 2003.

UK as a Tax Haven for Individual Domiciled or Resident Abroad

The present IHT system is very favourable for non UK domiciled individuals who may well be UK resident especially those with a domicile of origin being the form of domicile which is of a very clinging/tenacious character.

For a settlor domiciled outside the United Kingdom when a settlement is made, provided the assets are also outside the United Kingdom, the settlement will be and will remain excluded property for inheritance tax purposes, the domicile of the beneficiaries being irrelevant.

Accordingly, any non United Kingdom domiciled settlor who is envisaging acquiring or reacquiring a United Kingdom domicile should urgently grasp the nettle and set up the appropriate settlement (probably a discretionary trust) before he becomes domiciled in this country. Moreover, the Capital Taxes Office accepts that the property remains excluded property under section 48(3), Inheritance Tax Act 1984 - i.e. not liable to inheritance tax - notwithstanding that the settlor has reserved a benefit in the asset gifted, for example by being included as a beneficiary.

Under section 267, an individual is deemed to be United Kingdom domiciled for inheritance tax if he or she has been resident in the United Kingdom for 17 out of the last 20 years of assessment. Accordingly such an individual should establish such a discretionary trust prior to the commencement of this 17 year period. (Because income tax years of assessment are relevant the period of residence can be as little as 15 years in certain circumstances). The fact that the settlor becomes United Kingdom domiciled subsequent to the creation of the trust is immaterial for inheritance tax as to that trust fund.

This valuable estate planning proposal for non domiciliaries is, however, subject to five main traps which must be carefully guarded against.

- The first arises in the case of a settlement made by a non United Kingdom domiciled settlor, where there is an initial interest in possession in favour of the settlor or his spouse, followed by discretionary trusts. Under section 80, Inheritance Tax Act 1984, the settlement is treated for the purposes of the discretionary trust regime as having been made by the person with the interest in possession at the time of its termination. Under section 82 the position is that the settlor or spouse at the date of the original settlement and that person with the interest in possession at the time of the termination of that interest have to be domiciled outside the United Kingdom (i.e. on both occasions), to ensure that the property is treated as excluded. The moral is do not mix the trusts namely have one continuing trust, not an original form of trust which is subsequently varied with a different species.

- The second trap is to mix different categories of funds in one settlement. One should not have any United Kingdom assets in the discretionary trust of the non United Kingdom situs assets because these overseas assets will then be taken into account in computing the rate, on a cumulation basis, of the United Kingdom property - even though, standing alone, such United Kingdom property would be within the nil rate band.

- Thirdly it is preferable that no United Kingdom domiciled individual should provide any property to the trust as this could lose the section 48 excluded character of the trust. Although the Inland Revenue Tax Bulletin Feb 1997 p.398 has confirmed that a UK individual, as above, has probably created a separate settlement - this is subject to the vague qualification "if the circumstances so require".

- Fourthly the excluded property character of the trust overrides the gift with reservation rules. Therefore there is no objection in the settlor being an object of the discretionary trust. The settlor/beneficiary should not, however, be excluded subsequently by the trustees from benefiting in his or her lifetime as that will then constitute a deemed potentially exempt transfer Finance Act 1986 section 102(4).

- Fifthly, the creation of this settlement could have income tax disadvantages as a 'transfer of assets' under TA 1988 ss.739-740 as tightened up by FA 1997 s.81, notwithstanding non UK resident at the time of the transfer of assets.

Likely Form of Labour Government Legislation

- The Labour Government may adopt (e.g. FA 2001) the Law Commission report and draft Domicile Bill to the effect that foreigners resident here will be assessed to CGT and income tax on a residency basis and the IHT exemption may also cease to apply. This would be the end of the concept of domicile of origin as we know it.

- CGT exemption for non residents on certain transactions e.g. disposals on shore may end. Meanwhile, as from 17th March 1998 there has been considerable tightening of the definition of non-residence (see revised IR20) e.g. that a single or 3 tax year(s) abroad is insufficient, a basic period of **5** years is now required.

Suggested Action Now: IHT

An individual who is currently non UK domiciled should place the bulk of his assets in a non UK resident discretionary trust where such an individual could be included as a discretionary beneficiary without breaching the IHT gift with reservation provisions.

Discretionary trusts are the most flexible type and for that reason have been subject to fairly regular anti avoidance legislation. Nevertheless they are still eligible for considerable tax mitigation uses.