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DISCRETIONARY TRUSTS LOVE THEM OR HATE THEM?

One of the most powerful ways of mitigating inheritance tax is by use of a discretionary trust, the one tool which can be used to reduce your estate without increasing somebody else's. But what is your perception of this type of trust? Are they complex structures? Read on to find out!

Most trusts which are set up today are taxable under the relevant property regime if they have any element of flexibility. The most common post-March 2006 exceptions include trusts for disabled/vulnerable beneficiaries and immediate post-death interests created by will. In this article I will be focussing on the inheritance tax treatment of discretionary/flexible trusts created after March 2006 when the trust is initially created, where funds are added and any further IHT liability on death.

For the purposes of inheritance tax (IHT), the assets of a discretionary/flexible trust do not form part of any individual beneficiary's estate. However, it's not all good news as the relevant property regime compensates for this by imposing occasions of charge to inheritance tax at entry, periodically every 10 years and when capital exits the trust.

Due to such charges and additional reporting requirements, the tax treatment of discretionary trusts has often been viewed as being quite complex. But is this really the case? In this article I will provide you with worked examples which illustrate how IHT is calculated when a number of gifts are made and the effect on death. In a later article I will look specifically at the IHT charges that apply when capital leaves the trust and at each tenth year anniversary.

CREATION OF THE TRUST

A transfer into a discretionary trust during lifetime is a chargeable lifetime transfer (CLT) for IHT purposes.

A chargeable transfer is, broadly, a transfer of value which is not covered by an IHT exemption (for example, the spouse/civil partner exemption, normal expenditure out of income exemption or the annual exemption of £3,000).

The inheritance tax treatment of a chargeable transfer will depend on:

- the amount transferred
- the cumulative total of all chargeable transfers made by the settlor in the seven years prior to creating the trust, and
- any relief available (such as business or agricultural property relief).

No charge to IHT will arise (although, technically, this is a charge at 0%!) where the total amount transferred, when taken together with the sum of all the chargeable transfers made by the same settlor in the previous seven years, is less than the nil rate band (£325,000 for 2009/2010). Where the amount transferred is in excess of the settlor's available nil rate band, IHT may be payable and can be paid by the settlor or the trustees. We commonly refer to this as a lifetime charge to IHT and it is payable at 25% (to take account of grossing up) where the settlor pays the tax or at 20% where the trustees pay the tax.

Where clients may have executed discretionary trusts in the past and also made outright gifts, confusion can arise in determining how any previous transfers could impact any future planning.

If the settlor dies within seven years of executing the trust, tax must be recalculated at the 40% rate. This may result in additional tax becoming payable, although taper relief may apply to reduce the tax payable if the settlor has survived at least 3 years. This is illustrated in more detail in example 4.

When calculating the amount of the chargeable transfer, the available annual exemption of £3,000 can be deducted for the current tax year and the previous tax year, if it was not used.

Note that where both potentially exempt transfers (PETs) and chargeable lifetime transfers have been made in the same tax year, the Revenue will allocate the annual exemption (AE) in the order that the transfers are made. This means that, for maximum tax efficiency, chargeable transfers should generally be made before PETs, as discussed in my article entitled, 'Which gift do I make first?' which appeared in the November edition of *tech**talk***.



LIFETIME GIFTS

Where clients may have executed discretionary trusts in the past and also made outright gifts, confusion can arise in determining how any previous transfers could impact any future planning. In the examples below you will see how previous transfers may or may not have an impact on later gifts.

Example 1

Claudia set up a discretionary trust for £318,000 on 5 May 2008. She had made no other gifts or transfers in the previous seven years.

	£
Transfer into discretionary trust	318,000
Less AE (2008/09)	(3,000)
AE (2007/08 b/fwd)	(3,000)
	<u>312,000</u>

The nil rate band for the 2008/2009 tax year was £312,000, meaning that in this example there would be no lifetime tax payable as Claudia has not made any previous chargeable transfers and the gift does not therefore exceed her available nil rate band.

Example 2

Taking the same facts as above, lets say that Claudia had in fact made a previous gross chargeable transfer into discretionary trust of £105,000 on 1 June 2005. We now have to take account of this transfer to see the amount of nil rate band available to Claudia when she sets up the discretionary trust on 5 May 2007.

	£
Transfer into discretionary trust	318,000
Less AE (2008/09)	(3,000)
AE (2007/08 b/fwd)	(3,000)
	<u>312,000</u>
Nil rate band 2008/09	312,000
Less cumulative CLTs	<u>(105,000)</u>
Nil rate band remaining	(207,000)
Chargeable transfer	<u>105,000</u>
IHT (if paid by trustees) @ 20% =	£21,000
IHT (if paid by Claudia) @ 25% =	£26,250

These examples solely relate to gifts made to flexible trusts, however many clients will want to make outright gifts in lifetime to take advantage of the PET regime. When making outright gifts in lifetime, there is no lifetime IHT payable regardless of the size of the PET. The downside of this is that in making the gift the estate of the recipient beneficiary or donee is increased by the value of the PET. However, would there be any impact on lifetime tax payable on creation of an earlier or later created discretionary trust? Read on to find out!

Example 3

William made a transfer to a discretionary trust of £200,000 on 4 July 2006. Later that year he decided to make a gift to his sister on 1 August 2006 of £50,000. Then on 12 January 2009, he added £150,000 to his discretionary trust. The trustees agree to pay the tax due. Since 2007 William has also made use of his annual exemption of £3,000 on a regular basis.

Taking each of the gifts in turn:

1) 4 July 2006 – CLT

	£
Transfer into discretionary trust	200,000
Less AE (2006/07)	(3,000)
AE (2005/06 b/fwd)	(3,000)
Chargeable transfer	<u>194,000</u>

The nil rate band for 2006/2007 was £285,000 so there would be no lifetime tax payable on the transfer.

2) 1 August 2006 – PET

	£
Gift	50,000
Less AE (nil as used above)	–
PET	<u>50,000</u>

The gift to William's sister is a PET for IHT purposes, therefore there is no lifetime tax payable at the time the gift is made.

3) 12 January 2009 – CLT

	£
Addition into discretionary trust	150,000
Nil rate band 2009/10	325,000
Less cumulative CLTs	<u>(194,000)</u>
Nil rate band remaining	(131,000)
Chargeable transfer	<u>19,000</u>

IHT payable by trustees at 20% = £3,800.

This example therefore illustrates that for the purposes of calculating any lifetime tax due, it is only necessary to take account of any CLTs made in the seven years prior to execution of the discretionary trust. Any PETs can be ignored for these purposes. Note however that PETs created prior to discretionary trusts can impact on the periodic charge if the settlor dies within 7 years of the PET. This will be covered in detail in a later article.

INTERACTION BETWEEN LIFE AND DEATH

Whilst PETs can be ignored for the payment of any lifetime tax, this isn't the case where IHT becomes payable on death. For any transfers which fail as a result of death within seven years of making the transfer, tax on the gift must be recalculated at the death rates to determine whether any additional tax is payable. For these purposes, the nil rate band available to offset against the lifetime gift will be reduced by the value of chargeable transfers made in the seven year period preceding the gift (so that gifts made as far as 14 years prior to the death may impact the calculation process).

The example below illustrates the IHT payable on gifts made in lifetime and the impact of death.

Example 4

Gloria was single and sadly died aged 87 on 24 October 2009.

In her lifetime she had made a number of gifts. On 2 December 2003 she created a discretionary trust for £180,000. A couple of years later she gifted £80,000 to her son on the occasion of his marriage on 4 May 2005. On 3 August 2006 she settled £200,000 into discretionary trust. The trustees agreed to pay the tax due. Then on 2 September 2008 she made a gift to her brother of £100,000.

Lifetime

1) 2 December 2003 – CLT

	£
Transfer into discretionary trust	180,000
Less AE (2003/04)	(3,000)
AE (2002/03 b/fwd)	(3,000)
Chargeable transfer	<u>174,000</u>

The nil rate band for 2003/2004 was £255,000 so there would be no lifetime tax payable on the transfer.

2) 5 May 2005 – PET

	£
Gift to son	80,000
Less: Marriage Exemption	(5,000)
AE (2005/06)	(3,000)
AE (2004/05 b/fwd)	(3,000)
PET	<u>69,000</u>

The gift to Gloria's son is a PET for IHT purposes, therefore there is no lifetime tax payable.

Example 4 (continued)

3) 3 August 2006 – CLT

	£	£
Transfer into discretionary trust		200,000
Less AE (2006/07)		<u>(3,000)</u>
		197,000
Nil rate band 2006/07	285,000	
Less cumulative CLTs	<u>(174,000)</u>	
Nil rate band remaining		(111,000)
Chargeable transfer		<u>86,000</u>

IHT payable by trustees at 20% = £17,200

4) 2 September 2008 – PET

	£
Gift to brother	100,000
Less AE (2008/09)	(3,000)
AE (2007/08 b/fwd)	(3,000)
	<u>94,000</u>

The gift to Gloria's brother is a PET for IHT purposes, therefore there is no lifetime tax payable.

Death

1) 2 December 2003 – CLT

	£
Chargeable transfer	174,000
Covered by NRB	(174,000)
Taxable	<u>nil</u>

No IHT would be due as the nil rate band in the year of death is £325,000. Therefore the nil rate band remaining would be £151,000 (325,000 – 174,000).

2) 5 May 2005 – PET

	£
PET	69,000
Covered by NRB	(69,000)
Taxable	<u>nil</u>

Therefore the nil rate band remaining would be £82,000 (325,000 – 174,000 – 69,000).

3) 3 August 2006 – CLT

	£	£
Chargeable transfer		197,000
NRB (2009/2010)	325,000	
Less transfers in previous 7yrs	(174,000)	
	<u>(69,000)</u>	
Nil rate band remaining		(82,000)
Taxable		<u>115,000</u>
Tax @ 40%	£46,000	
Taper relief (3/4 years) @ 80%	£36,800	
Less lifetime tax paid	<u>(17,200)</u>	
IHT payable		<u>£19,600</u>

4) 2 September 2008 – PET

The gift to Gloria's brother becomes wholly chargeable as her nil rate band has been exhausted against transfers made in the seven years preceding her death. There would be no taper relief available because she has not survived for more than three years following the transfer.

IHT payable £94,000 @ 40% = £37,600.

DISCRETIONARY TRUST CREATED ON DEATH

Normally, where clients have chosen to include a discretionary trust in their will, the amount to be transferred to the trust on death is specifically identified as being the maximum amount that can be transferred without any IHT being payable. If however, a higher amount is to be transferred then the transfer into a discretionary trust on death receives the same tax treatment as illustrated above except:

- annual exemptions may not be deducted;
- inheritance tax is payable at 40% on the chargeable amount.

PAYMENT OF THE TAX

IHT is normally due six months after the end of the month of the transfer, unless that transfer was made between 6 April and 1 October when the due date is 30 April of the following year. As mentioned above, this tax can be paid by the settlor, but this will result in a larger transfer of value and increase the liability to IHT. For this reason, the tax tends to be paid by the trustees where the asset transferred is cash or liquid investments.

Notification of the chargeable transfer may also need to be made, using a form IHT100, within twelve months of the end of the month in which the transfer occurred. For further details please refer to our 'Inheritance tax: a guide to reporting requirements' which is available on the Literature library under the Trusts > Supporting guides section within the Adviser zone of our website.