

Creating a discretionary trust

(Lecture P1115 – 17.50 minutes)

When creating a discretionary trust, it does not matter whether the trust has been created before the Finance Act 2006 changes or after 22 March 2006 when it came in to effect.

IHT on discretionary trust created during lifetime

When a discretionary trust is created, the settlor passes their trust assets into a trust. For IHT this is treated as a chargeable lifetime transfer, and so can potentially trigger an IHT charge. This charge can be mitigated by ensuring that the settlor passes assets that qualify for business property or agricultural property relief into the trust or by making use of any remaining nil rate band that the settlor has not already used in chargeable transfers that they have made in the previous seven years.

Any assets that are settled into trusts that exceed the reliefs and exemptions that are available will result in IHT becoming payable. This will be due at a rate of 20% where the trust pays the tax out of the trust assets or at an effective 25% rate where the tax is paid by the settlor.

One of the benefits of creating a discretionary trust that is free from IHT on creation is that the value of the trust fund could avoid IHT on death at a rate of 40%. Provided that the settlor survives 7 years from creating the trust, no further IHT will fall due. It's important to remember that discretionary trusts are potentially liable to an IHT charge when assets leave the trust as well as every ten years from the trusts creation.

CGT on discretionary trust created during lifetime

Assets that are transferred into a trust is a disposal for CGT purposes. However, because the settlor is creating a discretionary trust, there is the option to defer the gain arising. Under s260 TCGA 1992, gains on transfers relating to IHT chargeable lifetime transfers can be deferred by effectively passing the gain into the hands of the trustees so that the gain will only crystallise when the assets leaves that trust, either as sale by the trustees or as a transfer to one of the beneficiaries. Thus s260 TCGA 1992 effectively provides a cashflow benefit rather than exempting a gain from CGT.

In deciding whether to defer any gain under s260 TCGA 1992, it is important to consider the rates of CGT likely to be suffered when the trust is set up without any deferral claim and compare that to what is likely to be suffered in the future when the trustees pass on the assets. So for example if entrepreneurs' relief is available when the assets are passed into the trust, a tax rate of 10% upfront may well be considered preferable to deferring the gain and suffering significantly higher rates in the future of 20% or even 28% tax.

Claiming principal private residence relief (PPRR)

Where the asset being transferred into a discretionary trust is the settlor's main residence, they will be eligible for PPRR. It is important to consider banking that relief at the point that the property goes into trust rather than deferring any gain under s260 TCGA 1992. Claiming to defer the gain, will invalidate any PPRR available up to that point.

In addition, once a s260 claim had been made, PPRR will no longer be available when the property leaves the trust, even if during the time the asset was in the trust it was occupied by one of the beneficiaries as their main residence.

So where the property was occupied by the settlor as their main residence prior to creating the trust and is then occupied by one of the beneficiaries as their main residence while it is held within the trust, s260 relief should be avoided as PPRR would be available to cover both the gain that crystallises when the trust is set up and also the gain that arises when the asset leaves the trust.

Additionally, where a property has been held in trust and the asset is passed to a beneficiary absolutely, if a s260 relief deferral relief claim is made, any future PPRR is also invalidated for the beneficiary.

Discretionary trust created on death

Where the testator has left a will transferring assets into a discretionary trust on their death:

- The assets will form part of their death estate and so, unless covered by any reliefs, exemptions or remaining nil rate band, will be taxable at 40%;
- There will no CGT to consider as the transfer is occurring on death with the trust effectively acquiring the assets for CGT purposes at the uplifted probate value.

Perpetuities and Accumulations Act 2009

This Act is effective from 6 April 2010 and extends the number of years that we can hold our assets in trust for. Prior to this Act the maximum period was 80 years.

Frequently this time limit would be mentioned within the Trust Deed. If we had a Deed that did not contain this clause, the previous Perpetuities and Accumulations legislation stipulated that maximum at 80 years.

From 6 April 2010, any existing trusts can opt to extend from 80 years to 100 years while any new trusts can run for up to 125 years.

Remember, it will be the trust Deed that will stipulate the relevant time period but with no mention, then the Perpetuities and Accumulations Act 2009 is the default.

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