



Discretionary trusts: love them or hate them?

One of the most powerful ways of mitigating inheritance tax (IHT) is by using a discretionary trust, the one tool which can be used to reduce a person's estate without increasing someone else's.

For the purposes of IHT, the assets of a discretionary trust do not form part of any individual beneficiary's estate. However, due to occasional charges to tax and additional reporting requirements, the tax treatment of discretionary trusts is often viewed as quite complex. In this article we look at the IHT treatment of discretionary trusts created after March 2006 at three points: when the trust is created, when funds are added and any further IHT liability on death, with worked examples illustrating how IHT is calculated when a number of gifts are made and on death.

Creation of the trust

A transfer into a discretionary trust is a chargeable lifetime transfer for IHT purposes (ie it is not covered by an IHT exemption). The tax treatment depends on:

- the amount transferred
- the total of all chargeable transfers made by the settlor in the seven years preceding the creation of the trust
- any relief available (eg business or agricultural property relief).

No charge to IHT arises where the total amount transferred, together with all the chargeable transfers made by the same settlor in the previous seven years, is less than the nil rate band (£325,000 for 09/10). If the amount transferred exceeds the nil rate band, any IHT can be paid by the settlor (at 25%) or the trustees (at 20%). If the settlor dies within seven years of executing the trust, tax must be recalculated at the 40% rate. However, taper relief may apply if the settlor has survived at least three years, reducing the additional amount due.

Lifetime gifts

Examples 1 and 2 show how previous transfers may or may not affect how subsequent gifts are taxed.

Many clients seek to take advantage of PETs, (which are free of IHT as long as the person making the gift survive seven years from the date of the gift) even though the estates of the beneficiaries are increased by the amount of

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 annual allowance (08/09)	(£3,000)
Annual allowance brought forward (07/08)	(£3,000)
	<u>£312,000</u>

The nil rate band was £312,000, so no lifetime tax was payable.

Example 2

Let's look at what happens if Claudia had already made a chargeable transfer into a discretionary trust of £105,000 on 1 June 2005.

Transfer into discretionary trust	£318,000
Less annual allowance (08/09)	(£3,000)
Annual allowance brought forward (07/08)	(£3,000)
	<u>£312,000</u>
Nil rate band 08/09	£312,000
Less cumulative chargeable lifetime transfers	(£105,000)
Nil rate band remaining	(£207,000)
Chargeable transfer	<u>£105,000</u>

IHT due if paid by trustees at 20%	£21,000
IHT due if paid by Claudia at 25%	£26,250

the gift. As you can see from example 3 overleaf, they are not taken into account when calculating lifetime tax due when placing funds in a discretionary trust.

Difference between life and death

However, PETs must be taken into account should the settlor die within seven years of making a PET, when tax on the gift needs to be recalculated to determine whether additional IHT is payable. The nil rate band available to offset against the lifetime gift is reduced by the value of chargeable transfers made in the seven years preceding the gift. As a result gifts made up to 14 years before death may affect the calculations.

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Example 3

William made a transfer to a discretionary trust of £200,000 on 4 July 2006. On 1 August 2006 he gave £50,000 to his sister. Then on 12 January 2009 he added £150,000 to his discretionary trust, with the trustees agreeing to pay the tax due. Since 2007 William has also made use of his annual exemptions.

Transfer into discretionary trust	£200,000
Less annual allowance 06/07	(£3,000)
Annual allowance 05/06 brought forward	(£3,000)
Chargeable transfer	<u>£194,000</u>

The nil rate band for 06/07 was £283,000 so no lifetime tax was payable.

Gift	£50,000
Annual allowance (already used above)	£0
PET	<u>£50,000</u>

The gift is a PET so no lifetime transfer is payable.

Added to discretionary trust	£150,000
Nil rate band 09/10	£325,000
Less cumulative lifetime transfers	(£194,000)
Nil rate band remaining	(£131,000)
Chargeable transfer	<u>£19,000</u>
IHT payable by trustees at 20%	£3,800

Discretionary trust created on death

If clients have included a discretionary trust in their will, the amount to be transferred to the trust is usually specified as being the maximum that can be transferred without any IHT being payable. However, if a higher amount is to be transferred, it is treated in the same way as in example 4 except:

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

In addition to discretionary trusts, there are other ways of minimising IHT, depending on the age and circumstances, and we would be pleased to advise on this.

LighthouseCarrwood is one of the UK's leading providers of financial planning services to professional practices. IHT planning is just one of our areas of expertise. To discuss how we could work with your firm in a way that suits you and benefits your business, please contact Mark Dallas, Managing Director, on 07899 981607. Mark.Dallas@lighthousegroup.plc.uk.

Example 4

Gloria set up a discretionary trust for £180,000 on 2 December 2003. She gave £80,000 to her son on his marriage on 4 May 2005. On 2 August 2006 she added £200,000 to the discretionary trust. The trustees agreed to pay the tax due. On 2 September 2008 she gave her brother £100,000.

Transfer into discretionary trust	£180,000
Less annual allowance 03/04	(£3,000)
Annual allowance 02/03 brought forward	(£3,000)
Chargeable transfer	<u>£174,000</u>

The nil rate band for 03/04 was £255,000 so no lifetime tax was payable.

Gift to son	£80,000
Less marriage exemption	(£5,000)
Less annual allowance 05/06	(£3,000)
Less annual allowance 04/05 brought forward	(£3,000)
PET (no lifetime transfer tax payable)	<u>£69,000</u>

Transfer into discretionary trust	£200,000
Less annual allowance 06/07	(£3,000)
	£197,000

Nil rate band 06/07 (£285,000- £174,000) remaining	(£111,000)
Chargeable transfer	<u>£86,000</u>
IHT payable by trustees at 20%	£17,200

Gift to brother	£100,000
Less annual allowance 08/09	(£3,000)
Annual allowance 07/08 brought forward	(£3,000)
PET, therefore no lifetime tax is payable	<u>£94,000</u>

On death: sadly, Gloria, who was not married, died aged 87 on 24 October 2009. IHT was calculated on her estate as follows:

Chargeable transfer	£174,000
Covered by nil rate band	(£174,000)

The nil rate band for the year is £325,000, leaving £151,000 available.

PET	£69,000
Covered by nil rate band	(£69,000)

This leaves £82,000 of the nil rate band available.

Chargeable lifetime transfer	£197,000
Less remaining nil rate band	(£82,000)

Taxable	£115,000
Tax at 40%	£46,000
Taper relief (3-4 years) at 80%	£36,800
Less lifetime tax paid	<u>£17,200</u>

IHT payable £19,600

Gift to brother less the original annual exemption	£94,000
Nil rate band remaining	£0

IHT payable at 40% £37,600

Source of all figures: Scottish Widows