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Counsel's Opinion on the Discounted Gift Trust

Discretionary Version

This document sets out the Counsel's Instructions submitted to the QC and the Counsel's opinion subsequently received.

N.B. References to sections apply to the Inheritance Tax Act 1984 as amended, unless otherwise stated.

1 Q. Would the gift to the trustees under the draft discretionary Discounted Gift instrument constitute a chargeable lifetime transfer? Would the settlement so created be treated as a settlement without interest in possession (i.e. discretionary) for the purposes of IHT?

A. The gift to the Trustees under the draft discretionary Discounted Gift Trust Deed will constitute a chargeable lifetime transfer within the meaning of s.2. The settlement so created will be treated as a settlement without an interest in possession, or discretionary settlement, for the purposes of Inheritance Tax, since neither the Settlor nor the beneficiaries is entitled as of right to the income of the Trust Fund or any part of it; and the Trust Fund will therefore be "relevant property" within the meaning of s.58.

2 Q. If the answer to the above is yes, would the value of the chargeable transfer equate to the total value of the property settled (i.e. the premium paid to the bond) less the value of the right retained by the settlor?

A. The value of the chargeable transfer will equate to the value of the property settled i.e. the premium paid on the bond less the value of the right retained by the Settlor, ascertained on actuarial principles. This is the amount "by which the value of the Settlor's estate immediately after the disposition" (i.e. after the Trust has been created) "is less than the value it would have had but for the disposition" within the meaning of s.3(1).

3 Q. Would the trust avoid the gift with reservation provisions within Section 102 of the Finance Act 1986?

A. The Settlor's contingent interest in the Settlor's Rights is in my opinion a properly carved out interest in property, "defined with the necessary precision" to use Lord Hoffman's words in Ingram v. I.R.C., [2000] 1 A.C.293 at p.305, and thus an interest that is not given rather than the reservation of a benefit out of an interest that is given; so that there is no gift with reservation of benefit within the meaning of s.102 of the Finance Act 1986 by reason of the retention by the Settlor of the Settlor's Rights. HM Revenue & Customs have confirmed their acceptance of this view in correspondence as recently as May 2006.

For the purposes of inheritance tax it is in theory harmless that the Settlor's spouse may benefit under the discretionary trust; but it will be borne in mind that, if any income should arise during the Settlor's lifetime, he will be taxable on that income, whether or not any part of it is paid to his spouse. In addition, if any money or other asset is paid or transferred to the Settlor's spouse during the Settlor's lifetime, care will need to be

taken that the Settlor does not himself benefit to any significant extent as a consequence, since for s.102 not to apply the property given, i.e. the Trust Fund other than the regular payments to which the Settlor is entitled under Clause 1, must be "enjoyed to the entire exclusion, or virtually to the entire exclusion, of the Settlor and of any benefit to him by contract or otherwise": FA 1986 s.102(1)(b). HMRC may be expected to investigate with some care any substantial distribution to the Settlor's spouse during the Settlor's lifetime to ensure that the Settlor does not benefit from such distribution. I do not consider that the exclusion in Clause 7 of the draft Trust Deed would afford a complete answer if, whether with or without the knowledge of the Trustees, the Settlor did in fact benefit from a distribution to his spouse.

4 Q. Would the trust avoid Sch. 20 Finance Act 1986 and in particular, does Counsel consider that, in order to do this, it is essential that neither the Settlor nor the Settlor's spouse is included as a life insured under the life insurance policy/bond?

A. As the Settlor's benefits are defined in the Trust Deed, they do not vary under the policy, and so Finance Act 1986 Sch.20 para.7 has no application: see para.7(1)(b).

Sch.20 para.7 applies where there is "a policy of insurance on the life of the donor or his spouse or on their joint lives". I am instructed that it is intended that the proposed bond will be effected on the lives of persons other than the Settlor or the Settlor's spouse. I do not consider that this is essential; but if this course is adopted, for this reason too Sch.20 para.7 will not apply.

5 Q. Would the trust give rise to a charge to income tax by reference to property previously owned under the POAT provisions in Sch.15 FA 2004?

A. HMRC have accepted that the pre-owned assets provisions do not apply to a discounted gift trust of the kind created by the Prudential draft Trust Deed: see the Revenue letter to the ABI which was published in Taxation Magazine for 18 November 2004 at pp.32-33, in which it was accepted that Finance Act 2004 Sch.15 para.8 had no application. It is conceivable that HMRC may revise their views and put forward an argument which departs from what they accepted in that letter; but in my opinion they were right to accept it, and I know of no current suggestion that they may seek to challenge the existing "carve outs" or any new "carve out" which takes the form of a Discounted Gift Discretionary Trust such as is effected by the Prudential draft Trust Deed.

6 Q. If the trust was established on a joint settlor basis (i.e. with husband and wife or registered civil partners as Settlor) would this present any additional issues from the perspective of either 'gifts with reservation' or pre-owned assets taxation? If so please can Counsel confirm what they are, what the consequences are and what action (if any) is recommended in connection with the drafting of the Declaration.

A. I do not consider that any additional issues arise if the Trust is established with husband and wife or registered civil partners as joint Settlors, from the point of view of either the gift with reservation provisions or the pre-owned asset provisions. In such a case neither Settlor is a beneficiary under the definitions in the draft Trust Deed, so that the considerations referred to in paragraph 3 above do not arise.

7 Q. On the Settlor's death would there be any value included in his/her estate in respect of his/her right to the specified payments?

A. The Settlor's contingent entitlement to regular payments under the Trust Deed will have no value on his death, and there will be nothing to include in his taxable estate on this account. Although the hypothesis on which tax on death is payable is that the deceased has made a transfer of value immediately before his death, the value transferred takes account of the fact that he has died and is therefore nil in the circumstances envisaged.

8 Q. For the purposes of calculating the 10-yearly periodic charge, does Counsel consider that the value of the relevant property for taxation purposes would be the value of the total trust fund (at that time) less the value of the outstanding value of the Settlor's rights at that time?

9 Q. Does Counsel consider the s.65 IHTA 1984 'Charge at other times' to be applicable to the payments made to the Settlor in respect of his entitlement to cash payments?

A. HMRC have stated in a letter dated 31 May 2006 that, in a case like this, the Settlor's right to reversionary capital payments, which is held on a bare trust for the Settlor absolutely, will not form part of the relevant property of the Trust at the 10-year anniversary.

It is in my view arguable that this is a concession on the part of the Revenue. The Settlor is not entitled to interest on the capital payments, or to any part of the income of the Trust Fund which may arise before they are raised and paid to him. The whole of the income is held, in default of appointment, on the trusts of clause 5, and the whole of the Trust Fund is this "property in which no qualifying interest in possession subsists" within the meaning of s.58. It seems to follow that the whole of the settled property should be valued at each 10-year anniversary; and that, on each occasion on which a payment is made to the Settlor, property comprised in the Settlement ceases to be relevant property and there is a charge to tax (an exit charge) under s.65(1). There is no equivalent, for property reverting to the Settlor from a discretionary trust, to the exemption from tax under s.53(3) when property reverts to the Settlor from an interest in possession trust; but it may be that the Revenue's acceptance that no charge to tax arises is influenced by the thought that there ought logically to be such an equivalent, since the situation to which s.53(3) is directed in the case where the Beneficiaries' Fund is held on interest in possession trusts is exactly the same as exists where it is held on discretionary trusts. Moreover the amount involved on each occasion when a periodic payment is made to the Settlor is comparatively small, and it is doubtful whether tax would be payable even if the Revenue were to change their view, bearing in mind that, under s.7(1), aggregation of chargeable transfers is limited to those made within the previous seven years. For the time being I think one can rely on the Revenue's letter, even if it is arguable that on a strict construction of the legislation an exit charge arises on every occasion when a payment is made to the Settlor, and the value of the Settlor's Rights should not be deducted from the value of the settled property for the purpose of the 10-year charge. If the Revenue should change their view at some time in the future, it may well be that the concession, if such it be, will continue to be applied to trusts created before the change.

If there should be held to be an exit charge whenever a payment was made to the Settlor, this would in no way be inconsistent with the fact that the value of the Settlor's Rights is properly deductible from the value transferred on the creation of the Trust. It is the logical corollary of the Revenue view, that there is no exit charge when a payment is made to the Settlor, that the Settlor's right to cash payments under Clause 1 of the draft Trust Deed will have to be valued at each 10-yearly anniversary and deducted from the value of the Trust Fund in order to arrive at the value of the Beneficiaries' Fund which will be subject to a charge to tax; and this is accepted by the Revenue in paragraph 2 of the letter of 31 May 2006, as mentioned above.

10 Q. Would the payments made to the Settlor be tax free in his hands and would not be treated as an annuity?

A. The Settlor's contingent right to the regular payments under the Trust will not in my opinion be treated as an annuity or other annual payment assessable under Taxes Act 1988 Schedule D Case III, or as an interest in possession for the purposes of the 1984 Act, whether the payments are made annually or at some other periodic interval. The payments made to the Settlor will be made out of capital and not out of income, and will constitute capital and not income in his hands, even if they are regular in amount and timing: cf Stevenson v Wishart, [1987] 1 W.L.R.1204, where Fox L.J. gives (at pp.1210-1211) a number of examples of recurring payments which are plainly capital and not income. The principle that money paid out of capital to which the payee is entitled as capital (and not merely to top up his income) is treated as capital for tax purposes will in my opinion apply if the Trust Deed takes the form of the draft accompanying my Instructions. The passage from the judgment of Finlay J in Brodie's Trustees v I.R.C., 17 T.C.492, which is quoted by Fox L.J. at p.1209, is apt:

"If the capital belonged to the person receiving the sums – if he or she was beneficially entitled not only to the income but the capital – then I should think that, when the payments were made, they ought to be regarded, and would be regarded, as payments out of capital, but where there is a right to the income, but the capital belongs to somebody else, then, if the payments out of capital are made and made in such a form that they come into the hands of the beneficiaries as income, it seems to me they are income and not the less income, because the source from which they came was – in the hands, not of the person receiving them, but in the hands of somebody else – capital."

Under Clause 1 of the draft Trust Deed the right to regular payments is expressed as a right to payments of capital; and so long as the Settlor is alive the particular slice of the capital which is directed to be paid to him "belongs" to him and not to anybody else from the date fixed for its payment; and the fact that the Settlor is not entitled to the income of the slice until the date on which it is directed to be raised emphasises its nature as capital.

11Q. Whether, if there are joint settlors, it would be necessary for the payments to the Settlors from the trust during their joint lifetime to be made to a joint account in their names and if not, why not and what alternatives would be available.

A. I do not consider that it is necessary for the regular payments to be made into a joint account where there are joint Settlors. Even if the premium for the bond is paid out of a joint account, each of the account holders will normally be treated as having provided half of it, and it would in my opinion be quite possible for the regular payments to be made into separate accounts in such proportions as the Settlors jointly direct. Clause 1.1 of the draft Trust Deed in fact provides that, where there are two Settlors, each shall have a right to half the amount of each regular payment; and I see no reason why each half should not be paid into a separate account.

12Q. The trustees are not prohibited from appointing benefits to the beneficiaries during the lifetime of the settlor, subject to not prejudicing their ability to satisfy the Settlor's right to payments. Does Counsel consider this power appropriate?

A. There is no reason why the Trustees should not appoint benefits to the Beneficiaries during the lifetime of the Settlor, provided that they are satisfied that to do so will not prejudice their ability to satisfy the Settlor's right to the regular payments directed by Clause 1 of the draft Trust Deed. The power of appointment conferred by Clause 2.2, and the power of advancement in Clause 2.4, are in appropriate terms for this purpose. The latter is expressed to be "subject to the Settlor's rights in clause 1". The former is not so expressed, but is limited to the Beneficiaries' Fund, which is itself defined as "the Trust Fund less the Settlor's Rights" and is moreover expressed to be subject to the restrictions in Clause 2.5. If the Trustees should pay or apply so much of the Trust Fund under these powers that there was a shortfall within the meaning of Clause 4, the Trustees could not in my opinion rely on the protection against personal liability conferred by the second sentence of Clause 4, since it would then be apparent that what they had applied exceeded the Beneficiaries' Fund or had been applied in disregard of the limitations in Clauses 2.4 and 2.5. The protection against a shortfall is in my opinion effective only to protect the Trustees if the value of the Trust Fund has fallen so far, without any appointment or advancement having been made by the Trustees, that there is insufficient to pay an amount due to the Settlor.

13Q. Is the default provision in clause 6 of Trust Provisions adequate to fully dispose of the property at the end of the Trust Period in such a way that the Settlor will have no entitlement via a resulting trust?

A. The Default Trusts in Clause 6 are effective to dispose wholly of the beneficial interests in the Trust Fund, since the ultimate gift to charity cannot fail; and no part of the Beneficiaries' Fund can therefore in any circumstances become held in trust for the Settlor on a resulting trust.

14 Q. Does the documentation Prudential has provided achieve the objectives as set out in the background? Does Counsel believe any modifications or additions are desirable or necessary?

A. In my opinion the documentation which Prudential has provided achieves the objects set out in my Instructions. I have suggested one or two minor modifications which do not affect the substance of the draft Trust Deed to any significant extent, and settled it accordingly. The references to Clauses in this Opinion are references to the numbered paragraphs or clauses of the Trust Provisions in the draft Trust Deed, though as will have been seen I have referred also to certain of the Definitions.

15Q. Does Counsel consider the trust is legally effective? Counsel is additionally requested to highlight any points that may affect its success from a tax standpoint.

A. The Trust is in my opinion legally effective, in the sense that both the Settlor and the Beneficiaries will have enforceable rights and interests according to its terms. I have drawn attention above to certain tax points which may need to be watched – see especially paragraphs 3 and 8 to 10. There are no other points that in my view need to be highlighted from a tax standpoint.

Edward Nugee QC
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Lincoln's Inn
17 April 2007

Additional Note

Following receipt of the original Opinion, minor amendments were made to the Trust Instrument and it was re-submitted to Counsel for settlement, which was received as follows.

I have considered the comments accompanying my Instructions.

The original Instructions sent on 26 April 2007 had an additional comment in manuscript, that "or out of capital as they think fit" had been added at the end of clause 2.10 on page 8. I have two versions of the draft Trust Deed, one with and one without these words. I think it would be better if these words were added so as to make it clear that the Trustees have a discretion whether to pay premiums out of capital (as would be more usual) or out of income.

Subject to this, I have no further comments on the draft Trust Deed. The additional words are not strictly essential and I have settled both drafts, as the point has no doubt been considered. My preference is for the one which includes these words.

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