DISCRETIONARY TRUSTS AND RESERVATIONS OF BENEFIT

Robert Venables QC[1]

The Revenue contend, rightly or wrongly, that if a settlor makes a gift to a trust of which he is a discretionary beneficiary, then that is a gift with reservation of benefit for inheritance tax purposes. A new insurance product is being launched on the market which is designed to circumvent this rule. The settlor is not in the first instance named as a beneficiary. The trustees are, however, given power to add him as a discretionary beneficiary, and then to benefit him. It is rumoured that the promoters of the product have obtained the opinion of Counsel in Gray's Inn to the effect that if and so long as the power to add the settlor as a discretionary beneficiary is not exercised, then there is no gift with reservation of benefit. I have not seen a copy of the Opinion.

Whether or not the Revenue are right in saying that there is a gift with reservation of benefit where a settlor is a discretionary beneficiary under a trust to which the gift is made is a moot point. At the end of this article, I append a relevant extract from my *Inheritance Tax Planning*, 2nd Edition, published by Key Haven Publications PLC.

Most settlors wisely proceed on the basis that the Revenue's view is correct. They do not wish to risk bequeathing to their heirs litigation to the Court of Appeal to establish that it is not. I cannot see a hap'orth of difference between a trust under which the trustees can execute a deed whereby in one clause they appoint capital or income to the settlor and on the other hand a trust under which the trustees can execute a deed whereby in clause one they add the settlor as a discretionary beneficiary and in clause two they appoint capital or income to him. Certainly, it is clear that in such a case the settlor would be caught by the income tax settlement provisions (TA 1988 Part XV), the transfers of assets abroad anti-avoidance provisions (TA 1988 Part XVII), the CGT UK Settlor Provisions (FA 1988 sch 10) and the CGT Offshore Settlor Provisions (FA 1991 sch 16).

Clearly, there is no distinction of substance in the two cases. Possibly, there is some technical difference which a modern court would find so compelling as to require it to treat differently the two cases which are in substance the same. If there is, I have not appreciated it. If any reader has any ideas what this might be, the Editors would be grateful to hear from him.

---

[1] Robert Venables QC, 24 Old Buildings, Lincoln's Inn, London WC2A 3UJ
Tel: (071) 242 2744 Fax: (071) 831 8095
Author of *Inheritance Tax Planning* (Second Edition - Dec 1989), *Lifetime Giving* (Oct 1989), *Preserving the Family Farm* (Second Edition - Oct 1989), *Capital Gains Tax Hold Over Relief* (Dec 1990), *Non-Resident Trusts* (Fourth Edition - Aug 1991) & many other books, all published by Key Haven Publications PLC.

Extract from Venables on Inheritance Tax Planning, 2nd Edition.

"5.3.4.1 Discretionary Trusts

If A settles property upon B, a widow, determinable upon her remarrying, remainder to himself, it is clear that he has gifted a determinable interest in respect of which there is no reservation of benefit. Suppose, however, A gifts property to trustees upon trust for B absolutely subject however to a power in the trustees to appoint the capital to A at any time during his life. (Readers will no doubt recognise this as a common form of Inheritance Trust formerly promoted by insurance companies.)

Can it be said that the revocable gift of capital is to be treated in the same way as a determinable gift of capital ? In that case, A will have disposed of one interest, namely an absolute but revocable interest, and retained the contingent remainder expectant on the determination of that interest.

Or is the correct analysis that A has made a gift of the entire capital but conferred a right of revoking the gift in circumstances such that he would then become entitled to the gifted property ?

The distinction is certainly a subtle one. Moreover, if there is a mischief in reservation of benefits - as to which I leave the reader to judge for himself - then a settlement with the power in the trustees to revoke the beneficial interests and to vest the settled property in the settlor must be at the heart of that mischief.

The same question arises wherever the trustees or any other person has power in their discretion to pay, apply, appoint or appropriate trust capital or income to or for the benefit of the settlor.

5.3.4.2 The Revenue View

The view of the Revenue in the ED era is set out in Dymond's Death Duties 15th edition (1973) at page 353:

"Where the deceased settled property on a discretionary trust under which he was one of the objects (as in ***Attorney General v Heywood*** *(1887), 19 QBD 326 and* ***Attorney General v Farrell*** *[1931] 1 KB 81) duty may be chargeable on his death ... on the whole settled property as being property which he has given and from which he was not entirely excluded. In view of the approval by the House of Lords in* ***Gartside v IRC*** *[1968] AC 553 of the decisions in* ***Heywood*** *and* ***Farrell*** *that an object of discretionary trusts has a sufficient "interest" for the purposes of s.38(2)(c) it does not seem that the settlor could be regarded as "entirely excluded" for the purpose of s.38(2)(a): at the same time, in view of the decisions in* ***Gartside*** *and in* ***Re Weir's Settlement Trusts*** *[1971] Ch.145 that such an object does not have a sufficient measurable "interest" for the purposes of the old s.2(1)(b) it does not seem that a measurable part of the property settled could be regarded as excluded from the gift within the principle of* ***Re Cochrane*** *[1906] 2 Ir.R. 200..."*

*The decisions in **Heywood** and **Farrell** are simply not in point, being on s.38(2)(c) of the Customs and Inland Revenue Act 1881 which applied to property passing under a settlement made by any person whereby an "interest" in such property for life or any other period determinable by reference to death was reserved to the settlor. The other cases are similarly **nihil ad rem**.*

Given that both cases expressly decided that a settlor who remains an object of the trustees' discretion during his life has on that account an "interest" in the settled property, the passage cited from Dymond is all the more remarkable.

The matter is really a great deal more complex than Dymond would suggest. That does not mean that the view therein expressed might not in fact be right, albeit for completely different reasons.

Since the publication of the first edition of this Report, the Revenue have confirmed that in their view "the inclusion of the settlor amongst the class of beneficiaries subject to powers contained in his trust is ... sufficient to constitute his gift as a gift with reservation." See Law Society's Gazette 10th December 1986 page 3728.

The Revenue draws no distinction between the case where the settlor is a named beneficiary and one in which there is a power to add himself as a beneficiary.

They also take the view, rightly in my opinion, that the inclusion of the settlor's spouse as an object would not of itself bring the provisions into play.

5.3.4.3 Mere Possibility of Enjoyment

If there is potentially a gift with reservation, the further question arises as to whether the settlor has reserved a benefit merely by creating the possibility of his benefiting in the exercise of the trustees' discretion or whether it is only if the trustees in fact exercise the discretion in his favour that he will benefit and thus the property will become subject to a reservation.

Applying the mischief rule, one would probably consider the former. However, that is arguably somewhat difficult to reconcile with the basis upon which one has decided there is a gift with reservation. For it is only if one regards the gift as being of the entire settled property that the Revenue gets thus far. Unless the power of revocation is in fact exercised what benefit does the settlor then enjoy?

If this view is in fact correct, then the settlor need have little fear of the reservation of benefit provisions. Ex hypothesi, they would be brought into play only if and to the extent to which the capital is revested in his estate. But in that event he will not be concerned with the application of s.102(3) for that would only apply if the capital is not in fact comprised in his estate immediately before his

death.[2]

The position may be different where the capital is revested in his estate by exercise of the power of revocation but is disposed of by him before his death, especially where the disposal is for full consideration which is represented in his estate at his death.

5.3.4.4 "Virtually to the Exclusion"

Even if the retention by the settlor of the ***spes*** *of recovering the settled property if the trustees in their discretion think fit is a benefit to the settlor which prevents the settled property being enjoyed to his entire exclusion, there is nevertheless much to be said for the view that if and so long as the trustees do not in fact exercise their power the property is nevertheless enjoyed "virtually to the entire exclusion" of the settlor. From the viewpoint of the other beneficiaries, the mere possibility of the gift being revoked does not trench upon their possession and enjoyment. From the point of view of the settlor, the benefit retained (the mere* ***spes****) is of minimal value and can be dismissed by the application of the* ***de minimis*** *principle."*

---

2 *The latest Cumulative Supplement to the Second Edition adds: "In the third paragraph, I omitted to consider the possibility that the settlor might enjoy an income benefit from the settled property. That could indeed be unfortunate. If, therefore, it is intended to benefit the settlor at all it will be much better to appoint capital rather than income to him."*