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Help sheet

Discretionary Trusts

Introduction

This information sheet sets out briefly for general guidance the main features of Discretionary Trusts and their tax implications. A number of important and technical points arise. Specific advice should be obtained before such a trust is used in any particular case.

Discretionary Trusts were not adversely affected by the 2006 changes to Inheritance Tax.

What is a Discretionary Trust?

Discretionary Trusts are so called because no beneficiary has a fixed entitlement and the trustees have complete discretion to decide what, if any, benefits should be given to each of the beneficiaries. The trustees are given powers of appointment which enable them to pay capital and income to one or more beneficiaries or to create new trusts for the beneficiaries.

The class of possible beneficiaries can be as wide or narrow as the person making the trust, known as the settlor, chooses. Mere inclusion in the class does not confer any legal right to receive any benefit. The settlor may retain or give the trustees power subsequently to nominate or to exclude beneficiaries. Not all of the beneficiaries need to be in existence when the trust is made.

The trustees will normally be given power not only to distribute income but instead to accumulate it as an addition to the capital of the trust.

A Discretionary Trust may continue for up to 125 years from its creation. This was limited to 80 years for trusts created before 6 April 2010. The settlor will provide how any assets which are not distributed by the trustees must devolve when the trust comes to an end.

Use of Discretionary Trusts

The main use of Discretionary Trusts is where flexibility is required. This may be, for example, in a case where someone wishes to make a gift either during lifetime or on death but has not yet decided who should eventually take the assets or in what proportions. Flexibility is maintained by listing all the possible beneficiaries and allowing the trustees to decide who takes what, if anything, when the time is right.

There are also certain tax reasons why a Discretionary Trust may be recommended (see below).

The Trustees

In view of the very wide powers which a Discretionary Trust normally confers on the trust it is vital to ensure that they can be entrusted to safeguard the trust assets and always to act in the best interests of the beneficiaries. It is desirable for the settlor to

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write a letter of wishes providing the trustees with non-binding guidance as to how the settlor would want them to act. It may also be desirable to appoint one or more professional or other independent trustees, particularly if the intended trustees are also possible beneficiaries.

Tax Implications

Inheritance Tax (IHT)

While a trust is discretionary, the trust assets are not comprised in any beneficiary's estate.

The funds are subjected to inheritance tax every ten years. Inheritance tax is payable at a rate of 6% on the value which exceeds the nil rate band (£325,000).

A charge may also arise when capital is paid out to a beneficiary. The rate of tax charged is a time-apportioned percentage of the ten year charge.

If the gift to the trust falls within the donor's nil rate band, inheritance tax charges are likely to be non-existent or very small.

If the settlor is not specifically excluded as a possible beneficiary, the trust assets will be treated as remaining subject to a reserved benefit and therefore still within his estate for inheritance tax.

Capital gains tax

Capital gains tax is often a bar to making gifts. If you gift an asset to an individual, it is treated as if it has been sold for its market value.

If however the asset is given to a trust, in most instances holdover relief can be claimed which means that the trust takes on the asset at its original cost rather than market value, and no capital gains tax is payable.

Where the settlor has a retained interest in the trust it is not possible to claim holdover relief. A retained interest includes the ability of the settlor's spouse and/or unmarried minor children to benefit.

When the trust makes gains on assets that it owns, it will be subject to capital gains tax at 28%. The trust has its own annual exemption equal to half of the amount allowed to individuals.

Income tax

As the income does not belong to any individual, the trust itself pays income tax. Apart from the first £1,000 of annual income which is taxed at the standard rate, income tax is charged at 50% on most types of income, and at 42.5% on dividend income.

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When income is distributed to beneficiaries, it is treated as having been taxed at source at 50%. If the beneficiary pays tax at a lower rate, they can reclaim the balance of the tax.

This means that in the case of a beneficiary who is not a taxpayer, for example a minor grandchild, all the tax paid by the trust can be reclaimed by the beneficiary.

The overall effect of the income tax rules for discretionary trusts is that generally the total income tax paid will be the same as if the beneficiary had received the income directly themselves. The only exception to this is dividend income. The way in which the tax rules work can lead to additional tax charges where dividend income is received by the trust and then distributed to a beneficiary. This can be mitigated by owning shares through a tax efficient 'wrapper'.

If the settlor or his/her spouse are possible beneficiaries of the trust all income will be taxed on the settlor. This is also the case for any income paid to the children of the settlor.

Summary

Discretionary trusts are essential tools for inheritance tax planning and can significantly reduce future liabilities. They are also a very effective way of protecting and preserving assets and family wealth.

The tax rules are complex, but with careful planning and good advice these charges can be kept to a minimum.

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