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## Discretionary Trusts

### 1. 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 are not adversely affected by the 2006 changes to Inheritance Tax.

### 2. 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. Usually, they are authorised to accumulate income during the first 21 years of the Trust, although there are certain other periods which the law allows.

A Discretionary Trust may continue for up to 80 years from its creation. The settlor will provide how any assets which are not distributed by the Trustees must devolve when the Trust comes to an end.

### 3. 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 paragraph 5 below).

### 4. The Trustees

In view of the very wide powers which a Discretionary Trust normally confers on the Trustees, 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 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.

### 5. Tax implications

#### 5.1 Inheritance tax ("IHT")

While a Trust is discretionary, the Trust assets are not comprised in any of the beneficiaries' estates for IHT purposes.

The creation of a Discretionary Trust is treated as a gift by the settlor and constitutes an initially chargeable transfer. If the value of the gift

exceeds the current IHT threshold of £312,000 (after deducting exemptions and reliefs), IHT is charged on the excess at 20%. If the settlor dies within 7 years, additional IHT may be payable. Any chargeable transfers in the preceding 7 years will reduce the available threshold. The value of the property when settled will continue to form part of the settlor's cumulative total of chargeable lifetime gifts for the full 7 years. The settlor's cumulative total will affect the rate of IHT paid on subsequent gifts or on death within the 7-year period. Normally, the transfer of assets to a discretionary trust should be made before other lifetime gifts to individuals.

The Trustees will be liable to IHT on the value of the Trust Fund every 10 years. There is also an exit charge when distributions of capital are made. If the value of the initial settled assets is below the IHT threshold and exemptions, there can be no liability to IHT during the first 10 years unless the assets which are settled qualify for either business or agricultural property relief. On each 10-year anniversary of the creation of the Trust, and when capital distributions are made, the maximum rate of IHT on each occasion is currently 6%.

In the case of a Trust made on or after 18 March 1986 if the settlor is not specifically excluded as a possible beneficiary, the Trust assets will be treated as remaining subject to a reserved benefit with the result that their value will remain part of the settlor's own estate for IHT purposes.

## 5.2 Capital gains tax ("CGT")

The Trustees will be liable to CGT currently at 18% in respect of any gains exceeding the Trustees'

available annual exemption, presently a maximum of £4,800.

While the interest of any beneficiary remains discretionary, there will be no uplift in the base value of the Trust assets on the beneficiary's death.

It should be possible to avoid any liability to CGT either on the creation or on the termination of a Discretionary Trust. The liability may be deferred irrespective of the nature of the assets by an election for hold-over relief (except as mentioned in the next paragraph).

Where the settlor has retained an interest in the Trust as a possible beneficiary, it is not possible to hold over gains to the Trust.

A settlor is regarded as having an interest if there are any circumstances whatsoever under which the assets within the Trust or the income arising to the Trustees may become payable to the settlor or to his/her spouse. The settlor will also be regarded as having an interest if his/her minor and unmarried children or stepchildren can benefit.

## 5.3 Income tax

The Trustees generally have to pay income tax at 40% except on dividends, although from 6 April 2006 they have had a £1,000 basic rate band. This will remain the rate on income which is accumulated within the Trust. However, a beneficiary who receives a distribution of income is given a credit for the 40% tax paid by the Trustees. If the beneficiary is a non-taxpayer or a taxpayer at the basic rate, he/she may reclaim the surplus tax previously paid. If the beneficiary is taxable at the higher

rate, he/she will have no further tax to pay.

Special rules apply to dividend income, but not to interest, rent or other income. Trustees of Discretionary Trusts pay tax at a special rate of 32.5% on dividend income received, given that dividend tax credits are not reclaimable. However, the Trustees may have additional income tax to pay if they distribute dividend income; each case must be looked at separately. A beneficiary (other than a higher rate tax payer) receiving dividend income will still be able to recover some or all of the 40% or so tax suffered by the Trustees when they received the dividend.

If the settlor or his/her spouse is a possible beneficiary, all the Trust income will normally be taxed in the settlor's hands during the settlor's lifetime. Even if the settlor and his/her spouse are excluded from any possible benefit, the Trust income would still be taxed in the settlor's hands if the settlor's minor and unmarried children or stepchildren receive distributions of income (or of capital to the extent, if any, that income has been accumulated).

## 6. Administration

A Discretionary Trust needs to be properly administered. This usually involves the Trustees filing annual tax returns and issuing appropriate tax deduction certificates to beneficiaries who have received income. The Trustees should also maintain Trust accounts and properly manage the Trust's property or investments. The amount of administrative work will depend on the nature of the Trust assets and on the frequency or otherwise of distributions of income and capital.

## 7. Conclusion

A Discretionary Trust may be suitable for an individual who wishes to transfer assets for the future benefit of a number of potential beneficiaries and who also wishes to retain the maximum flexibility as to the manner in which the income and capital is distributed.

A Discretionary Trust can be particularly attractive if the initial value falls below the settlor's IHT threshold. It should also be noted that the 40% income tax suffered by the Trustees may be partly or wholly recovered to the extent that income is distributed to beneficiaries who are not higher rate tax payers.

## 8. Disclaimer

This information sheet is written as a general guide. As any course of action must depend on your individual circumstances, you are strongly recommended to obtain specific professional advice before you proceed. We do not accept any responsibility for action which may be taken as a result of having read this information sheet.

**NOTE: The law is stated as at 6 April 2008.**

If you require further information, please contact Mark Politz or Simon Brown on 01892 510000 or by email at [mark.politz@ts-p.co.uk](mailto:mark.politz@ts-p.co.uk) or [simon.brown@ts-p.co.uk](mailto:simon.brown@ts-p.co.uk).

\* All references to the term "spouse" include a civil partner as defined by Section 1 of the Civil Partnership Act 2004