

Discretionary Trusts in Wills

Introduction

This information sheet sets out briefly for general guidance the main features of Discretionary Trusts in Wills 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.

What is a Discretionary Trust?

Discretionary Trusts are so called because no beneficiary has a fixed entitlement. The trustees, who are usually (but not always) the same persons as the executors, 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 their benefit. The class of possible beneficiaries can be as wide or narrow as the person making the Will, known as the 'testator', chooses. Mere inclusion in the class does not confer any legal right to receive any benefit. The testator may give the trustees power to nominate or to exclude beneficiaries. Not all of the beneficiaries need to be in existence when the Will is made, or when the trust takes effect on the death of the testator.

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. Historically, they have been authorised to accumulate income only for up to 21 years after the testator's death. However, this period is extended to the lifetime of the trust for Wills signed after 5 April 2010.

A Discretionary Trust may continue for up to 80 years from the date of the testator's

death. This is extended to 125 years for Wills signed after 5 April 2010. The testator will provide how any undistributed assets must devolve when the trust comes to an end.

Use of Discretionary Trusts

Before the introduction of a transferable Inheritance Tax ('IHT') nil rate band between spouses, Discretionary Trusts were frequently incorporated in Wills in order to make use of the nil rate band available on the first death. Such trusts are now less likely to be used for that purpose, but can have advantages in certain situations. Further details are available in our information sheets 'Inheritance Tax-Efficient Wills' and 'Nil Rate Band Discretionary Trusts in Wills for Spouses or Civil Partners'.

The main advantage of Discretionary Trusts is where flexibility is required. For example:

1 the testator may not have decided who should eventually take the assets or in what proportions;

2 the testator may require flexibility in case he fails before death to review his Will, in the light of changing tax and personal circumstances, or becomes unable to do so;

3 the testator may not want his detailed wishes regarding his estate to be of public knowledge after his death.

Trusts may also be useful for asset protection as far as the beneficiaries are concerned.

A Discretionary Trust will enable the testator's estate to be distributed in accordance with his wishes, but with flexibility in doing so if circumstances

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subsequently change, and in the most tax-efficient way.

Flexibility is maintained by listing all the possible beneficiaries and allowing the trustees to decide who takes what, if anything, and when.

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 trustees, it is vital to ensure that they can be relied upon to safeguard the trust assets and always to act in the best interests of the beneficiaries. It is desirable for the testator to write a letter of wishes providing the trustees with non-binding guidance as to how the testator would want them to act. It may also be sensible to appoint one or more professional or other independent trustees, particularly if the intended trustees are also possible beneficiaries.

Tax Implications

1 IHT

A Discretionary Trust is not exempt from IHT, so there may be an IHT liability on the testator's death, depending on the value of the estate.

The trust assets will not be treated as belonging to any of the beneficiaries for IHT purposes. There will be a potential charge to IHT on the trust fund every ten years. There will also be an exit charge when distributions of capital are made (except where the special treatment applies as mentioned below). The maximum rate of IHT on each occasion is currently 6%.

Any 'related settlements' will have to be taken into account when calculating the ten-year anniversary and exit charges. A related settlement is any other trust created by the Will, except a trust in which a surviving spouse has an immediate interest in possession. If the testator wishes to create trusts in his Will which will not be treated as related settlements, he should consider setting up a 'pilot' trust in his lifetime (or more than one on different days) and then leaving assets by Will to the lifetime trust(s).

If the value of the trust assets at the date of death is within the testator's available nil rate band (taking into account any chargeable gifts within the seven years before death) and assuming that there are no related settlements, there will be no IHT on any capital distributions made before the tenth anniversary of the testator's death. However, this may not be true where the assets which are settled qualify for either Business or Agricultural Property Relief at the testator's death.

It will normally be sensible to consider whether distributions should be made before the tenth anniversary, as the exit charge is based on the initial value of the trust assets. In contrast, the IHT charge on the tenth anniversary is based on the value of assets in the trust at that time.

Special treatment applies where a capital distribution is made, or the terms of the trust are altered, within two years after the testator's death. This is not a chargeable event for IHT purposes, so there can be no exit charge. Instead, the testator is treated for IHT purposes as having provided for the distribution or alteration in the Will. For example, if assets are distributed from the trust to the testator's widow within two years

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of his death, the spouse exemption will apply to those assets and any IHT previously paid can be recovered. However, the special treatment will not apply to an outright distribution made within the first three months from the date of death.

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

2 Capital Gains Tax ('CGT')

The trustees will be liable to CGT currently at 28% in respect of any gains since the testator's death exceeding the trustees' available annual exemption, which is presently a maximum of one half of the individual's annual exemption.

There will be no uplift in the base value of the trust assets for CGT purposes on the death of any beneficiary.

Should any beneficiary become entitled outright to the trust assets, the trustees will be treated as if they had disposed of them. Any CGT liability on such a disposal may be deferred, irrespective of the nature of the assets, by an election for hold-over relief (except as mentioned below).

Where capital distributions are made within two years after the testator's death, the CGT position will have to be considered carefully. If the trustees exercise their powers before the trust receives the relevant assets, there is no disposal by the trustees and the beneficiary is treated as acquiring those assets at probate value from the testator's estate. However, if the assets are no longer required for the administration of the estate and are vested in the trustees before they exercise their discretionary powers, the trustees are

deemed to have acquired the trust assets at probate value. In that event, on a subsequent capital distribution out of the trust, there will be a disposal by the trustees for CGT purposes. Hold-over relief will not be available if a distribution of non-business assets is made before the second anniversary of the testator's death.

3 Income Tax

From 6 April 2010, trustees of a Discretionary Trust generally have to pay Income Tax at 50%, except on income within the £1,000 standard rate band and, as mentioned below, on dividends. The trustees are not eligible for any personal allowances, but can deduct certain expenses when calculating their tax liability.

A beneficiary who receives a distribution of income is given a credit for the 50% tax paid by the trustees. If the beneficiary is a non-taxpayer or taxpayer at the basic or higher rate, he/she may reclaim the surplus tax previously paid. If the beneficiary is taxable at the top 50% rate, he/she will have no further tax to pay.

Trustees of Discretionary Trusts pay tax at a special rate of 42.5% on dividend income received. However, the trustees may have additional Income Tax to pay if they distribute dividend income and each case must be looked at separately. A beneficiary (other than a top rate taxpayer) receiving dividend income will still be able to recover some or all of the tax paid by the trustees.

Administration

A Discretionary Trust needs to be properly administered. This usually involves the trustees filing annual Tax Returns and issuing appropriate tax deduction

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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.

Conclusion

A Discretionary Will Trust may be suitable for a testator who wishes to leave assets for the future benefit of a number of potential beneficiaries, with maximum flexibility as to the manner in which the income and capital are distributed.

A Discretionary Trust can be particularly attractive if the initial value falls below the testator's nil rate band for IHT. It should also be noted that the Income Tax suffered by the trustees may be partly or wholly recovered to the extent that income is distributed to beneficiaries who pay tax at less than the trust rate.

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 1 July 2010.

If you require further information, please contact Mark Politz or Stuart Goodbody on 01892 510000 or by email at mark.politz@ts-p.co.uk or stuart.goodbody@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

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