Discretionary Trusts

'Very helpful supportive and understanding talked me through the whole experience explaining step by step, which is beneficial when having to make decisions.'

Wills, Trusts and Probate Client

Our team can advise and support you on setting up a discretionary trust alongside providing information around any tax implications.

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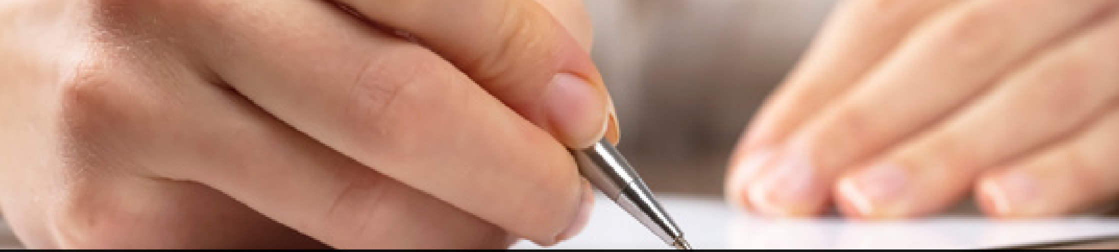

‘We have used Hegarty Solicitors before and found them to be excellent. Honest appraisals of what we require with no pushing to take out extras’

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What is a Discretionary Trust?

Trusts have been used by families for centuries to protect wealth, and a discretionary trust is one type available to help achieve this aim. A trust is the formal transfer of assets to a small group of people known as trustees.

A discretionary trust takes its name from the fact that no beneficiary has a fixed entitlement to either income or capital 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. They have no requirement to do this if they do not wish to, or do not see fit to.

For a discretionary trust to be formed it will need a settlor. This is the person or persons creating the trust by transferring assets to the trustees. This transfer can take place during the lifetime of a settlor or on their death. Either way, the settlor decides the class of potential beneficiaries and this can be as wide or narrow as they see fit. Just because an individual is included as a potential beneficiary does not mean they will receive any income, capital or benefit from the trust. If the trustees choose not to distribute the trust, they can opt to accumulate income within the trust as an addition to the capital of the trust.

The settlor may retain or give the trustees power to subsequently nominate or exclude beneficiaries. The settlor can be one of the trustees if they choose to be and can be a beneficiary of the trust, but this would remove all the tax advantages of setting up the trust so in practice this is avoided.

How long can a Discretionary Trust continue?

A discretionary trust may continue for up to 125 years from the date of its creation. The trust deed sets out the settlor’s wishes on how any assets which are not distributed by the trustees must devolve when the trust comes to an end.

Why use a Discretionary Trust?

The main benefit of a discretionary trust is the flexibility it can provide. It can also be an effective Inheritance Tax planning tool when used in the correct way.

Discretionary trusts are flexible, as they give the settlor the ability to transfer assets now but wait until an appropriate time to transfer the assets to the ultimate beneficiary or beneficiaries. This can be useful in cases where the ultimate beneficiary might be too young to have the asset outright or where a family situation may mean that the asset protection the discretionary trust gives is needed, for example bankruptcy or, in some situations, in the event of a divorce but with some caveats.

All the possible beneficiaries can be listed in the trust deed which gives the flexibility to the trustees to allow them to decide who receives what, if anything at all, when the time is right. There may also be a power for the settlor (or Trustees) to add to the class of beneficiaries.

The Trustees and their duties

The duties of a trustee are onerous, and an individual should consider these in detail before accepting an appointment to be a trustee.

The central principle for a trustee to bear in mind is that they must always act in the best interests of the beneficiaries and must act in good faith and safeguard the trust assets. A failure to do so is a breach of trust, for which the trustee may be personally liable.

The duties of trustees include:

- the duty to invest the trust property correctly,
- the duty to keep accounts and provide information to the beneficiaries if required,
- the duty to avoid a conflict of interest and the duty to act personally i.e., they cannot delegate their powers unless by way of a Trustee Power of Attorney. The investment powers may be delegated to an appropriately qualified investment manager.

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 wish them to act in respect of the trust property and the potential beneficiaries. It may also be desirable to appoint one or more "professional" or other independent trustees particularly if the intended trustees are also possible beneficiaries. This can help to demonstrate that the trustees as a whole are acting in the best interests of the beneficiaries. Generally, trustees need to act unanimously in their decisions.

The Court has the power to remove trustees if required.

Tax implications of a Discretionary Trust

Inheritance Tax ("IHT")

The creation of a Discretionary Trust is what is known as a chargeable lifetime transfer. This means that there could be an immediate IHT payment due depending on the circumstances of the settlor.

If the reduction in the settlor's estate following the gift to the trust exceeds the current IHT threshold of £325,000 (after deducting exemptions and reliefs, such as Agricultural and Business Relief) IHT is charged on the excess at a rate of 20%. It can be decided if the settlor or the trustees settle this liability, with differing consequences. If the settlor dies within 7 years, additional IHT may be payable. However, if the settlor survives for at least 7 years from the date of the transfer, the value is outside of their estate for IHT purposes.

Any chargeable transfers by the settlor in the 7 years before the trust is set up will reduce the available IHT threshold and could result in a higher immediate IHT charge.

Depending on the level of reduction to the settlor's estate it may be that IHT forms are required to be submitted to HM Revenue and Customs to report the transfer to the trust. This is irrespective of whether any IHT is actually payable.

The trustees will be liable to IHT on the value of the trust fund every 10 years. The amount payable will depend on the value of the trust assets, less liabilities, at the 10 year date after deducting any available exemptions and reliefs. There is also an "exit charge" when distributions of capital are made to beneficiaries and this will depend on the value of the assets leaving the trust.

The maximum rate of IHT due on the 10 year charge date is 6%, with the exit charge being a proportion of this based on the length of time the assets have been in the trust at the date of the exit.

In the case of a trust made on or after 18 March 1986, if the settlor and their spouse/civil partner is/are 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.

Due to the nature of a discretionary trust, if any beneficiary dies the trust assets do not form part of their estate and therefore no IHT charge will arise on the trustees.

Many other types of trust have, since the March 2006 changes, been treated for IHT purposes as if they are discretionary.

Capital Gains Tax ("CGT")

There is a mechanism which can make it possible to defer a CGT liability either on the creation or on the cessation of a discretionary trust. The liability may be deferred regardless of the nature of the assets being transferred by an election for holdover relief being made.

However, where the settlor is regarded as having an interest in the trust as a possible beneficiary, it is not possible to hold over gains on transfers in 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 their spouse/civil partner or their minor, unmarried children or stepchildren can benefit from the trust.

The rate at which trustees will be liable to CGT on capital gains is 20% (or at 28% on residential property) in respect of any capital gains exceeding the trustees' available annual exemption. This exemption is currently a maximum of one half of the individual's annual exemption. The rate is a maximum of £3,000 from 6 April 2023, and a maximum of £1,500 from 6 April 2024.

Disposals of UK residential property need to be reported, and any CGT paid, to HM Revenue and Customs within 60 days of the date of completion via a CGT Return.

Income Tax

Trustees of discretionary trusts pay income tax as follows:

- Up to a maximum of the first £1,000 of income is taxed at the "basic rate", this is 8.75% for dividend income or 20% for all other income.
- Tax is payable at 39.35% for dividend income above £1,000 (or less if applicable) or 45% for all other income. If the dividend income is distributed to a beneficiary the trustees may have to pay additional income tax to bring the rate up to 45%. This depends on the position of the trust and needs to be reviewed on a case by case basis.

- It can be possible for a beneficiary, who is not an additional rate taxpayer already, who receives an income distribution from the trust to make a claim to HM Revenue and Customs for any income tax overpaid when the rest of the beneficiary's income is taken into account in the tax year they receive the distribution. The repayment can be claimed either by completing a repayment claim form R40, or via the beneficiary's Self-Assessment Tax Return if appropriate.

If the settlor or their spouse/civil partner or their minor unmarried child/step-child is a possible beneficiary, all the trust income will normally be taxed on the settlor during their lifetime. This will therefore take into account their other income for the year when calculating the tax due.

Trust administration

It is a duty of the trustee to ensure that the discretionary trust is properly administered.

This usually includes:

- Registering the trust with HM Revenue and Customs on their Trust Registration Service within 90 days of the trust being created.
- Filing an IHT return for the setup of the trust, where appropriate this is due within 6 months from the end of the month the trust is created.
- Filing annual tax returns and issuing appropriate tax deduction certificates to beneficiaries who have received income, where the trust is a taxable trust. This may also include the preparation of annual accounts. Tax returns are due to HM Revenue and Customs by 31 January following the end of the tax year in question.
- At least annual, but can be more regular, trustee meetings to discuss items such as the trust property and investments, distributions to potential beneficiaries and other matters arising.

Is a Discretionary Trust right for you?

Using a discretionary trust may be the right option for you if you would like to transfer assets for the future benefit of a number of potential beneficiaries and where you would also like to retain flexibility as to how the income and capital is distributed.

Discretionary trusts can also be used as part of an effective IHT planning strategy.

However, the settlor needs to be aware that once the assets are transferred to the trustees, they no longer have any right to benefit from them, otherwise the tax planning benefits of the trust are lost.

A discretionary trust can be tax effective if the initial value falls below the settlor's IHT threshold or the property/assets

'We were guided carefully through every step to ensure that our wishes were reflected in the final document. The legal jargon was clearly explained in language that we could understand.'

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being transferred qualify for Agricultural and/or Business Relief, as this may mean that there is no immediate IHT payment due and if the settlor then survives for at least 7 years, the value of the assets transferred fall outside of the settlor's estate for IHT purposes.

From an income tax point of view the trust could be tax neutral depending on the income and distributions made to the beneficiaries. In any event it could be that the beneficiaries are basic or higher rate taxpayer so would receive a repayment of some of the income tax paid by the trustees.

It could be that a discretionary trust is not the best trust for your personal circumstances, so it is important to consider other trust structures which could be more appropriate.

Disclaimer: The information in this leaflet is for guidance only and is not a substitute for professional legal and tax advice. We do not accept any responsibility for action which may be taken or not taken as a result of having read this guide. The information in this guide is understood to be correct as of June 2023. E&OE

How can Hegarty help?

- We can help with the creation of a trust and liaise with the settlor to ensure that appropriate powers and duties are given to the Trustees and that the trust is registered with HM Revenue and Customs and complete all necessary HM Revenue and Customs forms.
- We can provide tax, estate planning and inheritance tax advice to ensure that the correct trust option is chosen for the settlor's individual circumstances.
- We can help with the ongoing administration of trusts, including preparing annual accounts and tax returns for the trustees as well as the 10 year anniversary and exit charge returns as required.
- We can complete tax returns and repayment claims on behalf of the beneficiaries. We can also assist with the settlor's tax return and holdover claim forms if required.
- We can put you in touch with independent financial advisors with experience of advising trusts on their investments.
- We can advise Trustees on their powers and duties under the trust instrument or under statute.
- We can act as professional Trustees and relieve you of the risk and administration that the role entails.
- We can help bring trusts to an end when required and advise on the most tax efficient manner to achieve this, and deal with all associated paperwork and reporting to HM Revenue and Customs.

Please contact Tom Moore our Tax, Trust and Estate Planning Specialist on 01733 295691 or email tom.moore@hegarty.co.uk or contact any member of our Trust and Probate Department to discuss further.

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