

Discretionary Trusts

A trust is a legal arrangement whereby money, property or other assets ('the trust fund') are held and managed by persons ('the trustees') for the benefit of others ('the beneficiaries').

There are various types of trusts which perform a range of different functions. In the case of a trust created by Will, the trust begins on the date of the testator's death.

1. What is a Discretionary Trust?

A discretionary trust is a trust where the beneficiaries and their entitlements to the trust fund are not fixed, but are determined by the trustees.

The trusts are discretionary in two respects. First, the trustees have power to determine which of the beneficiaries (from a named class) will receive payments from the trust fund and second, how much they actually receive and when. These decisions are entirely at the trustees' discretion. So a beneficiary has no actual right to any part of the trust fund and no way of knowing whether the discretion will be exercised in his favour. All he has is a right to be considered by the trustees.

2. Why might I want a Discretionary Trust?

There are many reasons for creating discretionary trusts by Will. For most people the benefits are the flexibility provided and asset protection. For a few people there may also be tax advantages.

Flexibility

The discretion given to trustees means that they can adapt the amounts paid and to whom to the changing needs of all the beneficiaries. So they will be suitable for people who have identified a particular group of persons they would like to benefit, but are unsure which of them will need financial help in the future and in what proportions. For example a middle aged man wishing to provide fairly for all his children may worry that at his death their requirements may be very different – one child may be adult and financially independent, whilst another may be very young and still at school.

Asset Protection

Discretionary Trusts can be used to:

- Exercise control over young and financially irresponsible beneficiaries
- Protect beneficiaries against creditors in the event of a beneficiary's bankruptcy
- Protect assets in the event of divorce of a beneficiary
- Provide for disabled beneficiaries who are unable to manage their own property, without prejudicing means tested benefits
- Provide for beneficiaries who may have an alcohol, drug or gambling addiction

Inheritance Tax Mitigation

For most people introduction of the transferable nil rate band between married couples/civil partners has rendered use of discretionary trusts redundant for tax planning purposes. However for a few people, nil rate band discretionary trusts can still be beneficial, including to:

- Businessmen and farmers – in helping to preserve their Business Property Relief (BPR) and Agricultural Property Relief (APR)
- Widows and Widowers – in maximising their available nil rate bands
- People who have assets the growth in value of which is likely to exceed the nil rate band

Such people will need further individual tax advice.

3. The Trustees

As a result of the power and freedom given to trustees it is important to think carefully about who should be appointed. It is a personal decision, but usually trusted family members or close friends are chosen. Trustees can themselves be beneficiaries of the trusts. It is recommended to appoint between 2–4 trustees and sometimes it may be appropriate to appoint a professional trustee, depending on the complexity of the trust.

4. Guidance to Trustees

It is important that the testator leaves for the guidance of his trustees some expression of his wishes as to the way in which they should exercise their discretionary powers. Usually this takes the form of a separate Expression of Wishes statement telling the trustees roughly what the testator would like them to do with the trust fund. Unlike the Will this is a private document for the trustees only. It is not legally binding on them though as they need to be free to use their own initiative if changing circumstances of the beneficiaries (fiscal or personal) should require it. The Expression should be stored alongside the Will and should be reviewed periodically to ensure it is kept up to date.

5. Tax Consequences

Discretionary trusts are treated as separate entities for tax purposes, so will be subject to tax in much the same way as individuals.

For Income Tax purposes, the first £1,000 of income is taxed at 'the standard rate' currently of 20%. Income in excess of this is taxed at 'the trust rate' of 50% or 42.5% for dividend income.

The rate of Capital Gains Tax for trustees is 28%. The annual exemption for most trusts is £5,300 (half the individual allowance).

With regard to Inheritance Tax, because the beneficiaries do not own the trust their deaths are not an occasion for tax. Instead these trusts are subject to their own tax regime. This is complicated but in essence there are two occasions where Inheritance Tax is charged:

- The 10 Yearly anniversary Charge – which arises every 10 years after creation of the trust, at the rate currently of 6% of the market value of the trust fund at the time of the charge
- Exit Charges – which are paid every time assets leave the fund on being paid to beneficiaries. These are calculated by reference to how long the assets have been held in trust since the last 10 yearly charge, so will be a proportion of 6%

The effective Inheritance Tax rate is therefore currently 0.6% per annum, which is modest. However this rate of tax could well rise in the future.

6. Disadvantages of Discretionary Trusts

Loss of Control - by giving wide powers to the trustees a testator places outside his own control the detailed disposition of his property

Administrative Requirements -the relevant tax and general law relating to discretionary trusts is complex.

Annual accounts and tax returns have to be completed and tax may be payable from time to time

Expense -the trustees may well have to take legal, accountancy and investment advice as and when required and this will obviously incur expense for the trust as such fees will be payable from the trust fund

In appropriate cases the many advantages of discretionary trusts will outweigh the disadvantages referred to.

The information contained in this leaflet is intended as a guide only.

It is not intended to be comprehensive or to provide specific legal advice and should not be relied upon as doing so.

Further detailed advice appropriate to your individual circumstances should be obtained from our Legal Department,

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