Client Guide to Discretionary Trusts

What is a Discretionary Trust?

A Discretionary Trust is a trust under which the trustees have the discretion to pay capital or income to any beneficiary or class of beneficiaries nominated by the settlor (who will be the person setting up the trust). The trust may for example authorise a payment to "any of my (i.e. the settlor's) children or grandchildren". The trustees would then be able to make payments to one, some or all of the beneficiaries as they see fit. They also have the option to accumulate the income without making any payments for the length of the trust (i.e. reinvesting the interest from the trust with the trust capital).

Why is it used?

In recent years Discretionary Trusts have become more and more popular as a vehicle for mitigating income tax, capital gains tax and inheritance tax liabilities.

They are also used to protect assets that may otherwise be wasted. For example, if a settlor wishes to leave his estate to his children one of whom may be spendthrift or who suffers illness (e.g. alcoholism, schizophrenia etc.) or who may be the subject of bankruptcy proceedings or divorce then the settlor may instruct his trustees to ensure that the particular beneficiary concerned may be provided for in such a way as to ensure they are looked after without the worry of the legacy being frittered away or wasted or lost to a receiver. In the case of a beneficiary receiving benefit, the value of capital in a discretionary trust is not counted.

The most frequent reasons for using Discretionary Trusts:

(a) To reduce the value of the estate of the settlor and therefore reduce the potential inheritance tax bill.

(b) To pass wealth to beneficiaries while retaining control over it.

(c) To pass wealth to beneficiaries but have protection against future difficulties of a beneficiary, e.g. financial difficulties.

The Mechanics of the Trust

A Discretionary Trust is created by a deed or Will, which outlines the rules or legal basis on which the trust will operate. It defines the purpose of the trust, the trustees who manage it, what funds there are and who is to benefit from the funds and when.

The person providing the funds is called the settlor. By putting money, investments or property (called the trust fund) into the trust he is legally transferring ownership of that fund from himself. Once that fund is owned by the trust it can only be used according to the rules of the trust deed. If the

settlor falls upon hard times, he cannot ask for the money back. For inheritance tax planning purposes the trust deed is often the Will of the settlor although large estates may also require a lifetime transfer into trust.

The management of the trust and the trust fund is given to up to 4 trustees nominated in the trust deed. The settlor can be a trustee. The actions of the trustees are regulated by the trust deed and by law under the Trustee Acts.

A Discretionary Trust is one where the trust deed authorises the trustees to invest the trust fund and deal with any income and/or the capital itself as they see fit i.e. at their discretion. They can therefore retain all the income within the trust and allow it to roll up or they can pay out all or some of the income and/or capital to beneficiaries.

In a Discretionary Trust the deed will contain a list of people to whom payments may be made. These are the beneficiaries and may include descendants who are as yet unborn.

As discretion for any payment is in the hands of the trustees, the beneficiaries are not entitled to a particular pay out in a particular year. It will be entirely up to the trustees to decide whether any or all or none of the beneficiaries will receive anything.

The terms of the trust deed can of course be tailored to suit the requirements of each settlor. It is also usual for a settlor to give the trustees a letter of wishes indicating factors he would like them to take into account when deciding whether to make any payment. This could indicate a priority amongst beneficiaries on occasions such as marriage, house purchase or birth of children when the settlor would like a payment to be made. The trustees can be guided by this letter of wishes but cannot be bound by it.

Taxation of Discretionary Trusts

Tax on establishing the Trust

If assets are sold in order to generate funds to be transferred to the trust fund then Capital Gains Tax may arise. If the specific asset is transferred to the trust then Capital Gains Tax can in some circumstances be held over.

For inheritance tax purposes, putting assets into trust in the settlor's lifetime is treated as a chargeable transfer. The settlor's annual £3,000 exemption may be taken into consideration. Provided the transfer does not exceed the available nil rate band there will be no immediate tax liability. The law currently allows that should the settlor survive the gift by 7 years it should not be included when accounting for any future inheritance tax liability on his estate.

Tax on assets in the Trust

Discretionary Trusts are taxed in their own particular way. If income in any tax year is less than £1,000 and received net, no further tax is payable. Otherwise income tax is charged at 50% on income received from banks and

42.5% on dividend income, less a credit for any tax already deducted, e.g. interest or dividends received net of tax.

If in turn some income is paid out to a beneficiary, a credit for the tax is also passed on and taken into account in the beneficiary's own tax calculation. For capital gains tax trustees only receive one-half of the annual exemption due to an individual and pay capital gains tax at the top rate.

The trust can last a maximum of 125 years. There is a revaluation every 10 years and may be an inheritance tax charge based on the value of the trust fund. There can also be charges when capital passes out of the trust.

It should be noted that if the settlor or his or spouse or any of their minor children are included in the list of beneficiaries (unless the trust is in a Will), then any income tax or capital gains tax charge will be made on the settlor at his tax rates and not on the trust.

Example of Nil Rate Band Discretionary Trust

Mr and Mrs Smith own a property, which they hold as joint tenants, and which is their main residence, valued at £300,000. They have other assets and investments of £150,000 each, which is held in their own names. (Total = £600,000). They wish to leave their estates to each other and on the death of the survivor for the estate to be divided between their two children equally.

If no action is taken, then on the death of Mr Smith there will be no IHT due as Mrs Smith is entitled to claim spouse exemption. On the death of Mrs Smith (providing the value of the estate remains the same) there will be no Inheritance Tax as both Mr Smith's nil rate band (£325,000 currently) and Mrs Smith's can be utilised. Although there are 2 nil rate bands their values are currently frozen and in any event are likely to increase only in line with inflation. If on the first death there are assets which are likely to increase in value ahead of any increase in the nil rate band then using a discretionary trust can help to reduce tax which would otherwise be payable.

We advise that trustees should meet to consider the operation of the trust at least once every six months and more frequently where circumstances dictate.

If one partner has been given assets by the other this is something of which we should be made aware as different inheritance tax rules can apply.

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We are required to comply with the law on money laundering which means that we may carry out an identity search for money laundering purposes and we may carry out a search even if we have carried out one previously. We will also additionally ask you to produce identification evidence, which will ideally be your passport or driver's licence. We will copy the document and return it to you. We may ask you to produce further identification evidence if required as part of our on-going customer due diligence. The cost of the money-laundering search we carry out is at least £3.00 plus VAT (£3.53) per name and we will add this fee to our bill. In the case of a company we will undertake appropriate searches and the cost of these will vary and will be in addition to the cost of any individual search fees.

If we are acting for you as representative of a company, trust or other body (including a club) we will need to establish the beneficial owner (as defined) of the organisation and we will almost certainly require further evidence of identity in respect of other members of the organisation. We will advise you specifically where this is the case.

We must see satisfactory evidence of identity from clients or report unusual circumstances even in relation to existing clients to the appropriate authorities.

Until we have satisfactory evidence of identity we will not be able to proceed with acting for you.

Under the Proceeds of Crime Act 2002 a criminal offence is committed if you or we become concerned in an arrangement which facilitates the acquisition,

retention, use or control of criminal property. Accordingly you must be aware that if we are given any information alerting us to an offence then you and/or us must report the matter to the National Crime Agency (NCA) and failure to do so is an offence. This can be information about you, your spouse, or indeed any other person. Proceeds of crime are any monies which have arisen as a result of any crime and include, for example, monies saved as a result of tax evasion, cash taken out of a business and not declared, cash payments for any work not disclosed for the purpose of tax and/or benefit entitlement.

In certain circumstances it may be necessary for us to make a report to NCA before we can continue to act and it may be necessary for us to make such a report without reference to you. Our obligations under the Proceeds of Crime Act 2002 override client confidentiality and privilege. Such a report may lead you to discover that you are the subject of a criminal investigation if any offence appears to have been committed.

We confirm that any fee earner time spent on the matter addressing any issues arising from the Act, will be charged in the same manner as any other work undertaken on your behalf.

We are only authorised and able to provide advice on the law in England and Wales.

Any work we do for you may involve tax or duty implications. Unless we inform you in writing to the contrary we will not advise you on such tax or duty matters and you are advised to consult a taxation specialist in this respect.

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