
Discretionary Trusts

A discretionary trust is a flexible trust under which no beneficiary has an automatic right to receive assets. Instead, it is the trustees who have the power to decide who, from a list of beneficiaries, should receive the money or property held in the trust, and when.

What is a Discretionary Trust?

This type of trust is commonly accompanied with a letter of wishes, setting out how you wish the trustees to deal with the trust going forward, but not all discretionary trusts have a letter of wishes.

It is possible to set up a discretionary trust during your lifetime, and also in your Will, and there are many personal and tax reasons why you might be considering this.

You may not consider that children or grandchildren are mature enough to deal with large sums of money for example, or you do not wish to make gifts to children whose own estates would suffer Inheritance Tax at death. Maybe you are worried about money being vulnerable on divorce or bankruptcy of a beneficiary, or you might simply prefer your trustees to keep overall control of the trust fund.

This factsheet focuses on some of the inheritance tax (IHT) reasons and consequences, but every situation is different so you'll need to take advice based on your own personal circumstances, before you decide what to do.

Making a gift to a Discretionary Trust

One fairly simple way to reduce the value of your estate for IHT is by making gifts during your lifetime. Sometimes however, it makes more sense to make a gift into a discretionary trust where several people may benefit, rather than to a person outright.

Special rates of tax apply to discretionary trusts and this is because they fall in to what is known as the 'relevant property regime'. Notwithstanding this special tax regime however, some clients still prefer to make a gift to a discretionary trust because this better achieves their overall objectives.

The IHT rules for relevant property trusts have three elements:

1 An entry charge

If you make a gift during your lifetime into a discretionary trust, and the amount of the gift exceeds the 'nil rate band' (currently £325,000), then you will have to pay lifetime IHT at 20% of the amount which exceeds that sum. Also bear in mind that if you've made any other gifts or transfers in the preceding seven years, then this will be taken into account to work out the available nil rate band.

If the trust is created in your Will the rate is 40%, but then of course the tax is payable after you've died and there may be exemptions and reliefs you can use to reduce the amount that your estate has to pay.

If you make a gift during your lifetime and die within seven years, the lifetime charge is recalculated at the death rate, with credit for tax already paid and reduced rates after three years.

2 A ten-year anniversary (periodic) charge:

This is a charge on the value of the trust fund at each ten-year anniversary of its creation, up to a maximum rate of 6%.

The anniversaries are counted from the creation of the trust, even if it was not a relevant property trust at that time, but the charge is reduced if assets are not relevant property for the full ten years.

3 An exit (proportionate) charge:

This is a charge on the reduction in value of a trust fund when trustees distribute assets to beneficiaries, or when some of the assets stop being in the relevant property trust. This might be because they are moved into a different type of trust for some reason. This charge is based on the number of quarter years that have passed in a ten-year period.

The government intends to introduce changes to the taxation of relevant property trusts in a future Finance Bill. The measures are expected to simplify the way that IHT is charged on ten-year anniversaries and exits. It is also expected to prevent people from using additions to lifetime trusts via the provisions of their will on death to avoid future IHT charges within those trusts. For more information about this, please ask.

What about putting a discretionary trust in my Will?

If a discretionary trust is contained in a Will then you'll probably hear it called a 'Will Trust', although any type of trust could be a Will trust if it's created in a Will. There are

no exit charges on distributions made during the period of two years after the trust is created, because these distributions are treated as if made in the person's Will. This means that if the trustees decided after your death that running the trust was not in the best interests of the beneficiaries, they could decide to wind the trust up and distribute the money or property to the people named.

A discretionary trust in a Will might also qualify for different IHT status from the date of the person's death if, for example, the trustees decided to create a different type of trust for the deceased person's young children. For tax reasons however, you usually need to wait for three months after the deceased person has died, to make any changes to the arrangements.

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