

Discretionary Trusts

Discretionary trusts are a flexible type of trust, which give the people you appoint as your trustees considerable powers over how the trust assets are handled.

Under a discretionary trust, beneficiaries do not have any automatic right to receive the money and/or property held in the trust. Instead, the trustees will decide when to distribute assets or income out of the trust and how much a beneficiary will receive if anything. The trustees' powers of choice (or 'discretion') can have many legal implications, and it is important to be aware of these before deciding whether a discretionary trust is right for you. This help guide will guide you through some of the main points to consider.

How are Discretionary Trusts created?

You can set up a discretionary trust during your lifetime and/or in the terms of your Will. If you create one through your Will, the trust will take effect after you have passed away.

Discretionary trusts are usually accompanied by a letter of wishes. This sets out how you wish your trustees to deal with the trust assets and can be used to explain your intentions behind the trust. It is possible to create a discretionary trust without making a letter of wishes, however.

The benefits of Discretionary Trusts

There are many different reasons why you might wish to set up a discretionary trust. Some of the potential advantages are described below, though many of them will depend upon your circumstances and what you wish the trust to achieve.

Reducing the value of your estate

In most cases, putting assets into a discretionary trust during your lifetime will serve to remove those assets from your estate, reducing the value of your estate at the time of your death when it is assessed for inheritance tax (IHT).

Whilst it may be simpler to reduce your estate value by just making gifts during your lifetime, there could be situations where transferring an asset into a discretionary trust is preferable – perhaps where you would like several people to potentially benefit from the asset, rather than giving the asset to a particular individual outright.

Providing for beneficiaries without giving rights to the trust assets

In some situations, you may wish to provide for certain loved ones, without them receiving the assets right away. You might prefer your appointed trustees to control the trust assets instead.

For example, you might feel your children or grandchildren are not mature enough to deal with large sums of money, or you do not wish to make gifts to children whose own estates would suffer increased IHT upon their death.

A less common situation could be where you want to provide for beneficiaries who are going through bankruptcy or divorce proceedings. If you were to give the assets to those beneficiaries, or create certain other kinds of trust, the beneficiaries would be treated as owning the trust assets and so the assets would be vulnerable to being taken away or shared out.

Flexibility

Setting up a trust is often part of a long-term financial plan. Without knowing what the future holds, it can be difficult to predict which of your beneficiaries might be in greatest need of the trust assets later. Through a discretionary trust, your trustees can decide when and how the trust assets and income are to be divided amongst the beneficiaries, perhaps helping your loved ones in ways which you didn't imagine when setting up the trust.

In a similar way, a discretionary trust can allow you to provide for beneficiaries whom you may never meet, such as great-grandchildren or perhaps even more distant descendants. When creating the trust, you can specify a 'class' of beneficiaries (such as 'all of my grandchildren who reach the age of 21'). This means you can benefit people without having to list them all by name.

The drawbacks of Discretionary Trusts

Some beneficiaries may receive nothing from the trust

Because trustees of a discretionary trust can choose which beneficiaries receive the trust assets, it is possible for them to decide that one or more beneficiaries should receive nothing. Whilst this may be in line with your intentions for the trust, you should consider the effects this may have on the potential beneficiaries. It may lead to jealousy and even legal disputes between your loved ones.

Trustees are given a lot of responsibility

Discretionary trusts give a lot of power to the appointed trustees. This makes it even more important than usual to select your trustees with care.

Complexity

Connected to the consideration above, is the complexity of administering a discretionary trust. You may feel that friends and family would be overwhelmed by the responsibility, and the greater difficulty, of handling a discretionary trust instead of a simpler arrangement. This could mean appointing at least one professional trustee alongside them and, naturally, this brings with it further costs. Even with non-professional trustees, the more work required to manage a trust, the higher its administration costs. All of which can whittle down the value held within the trust. That said, in some cases, appointing a professional trustee makes sense.

Taxation

Tax can be a double-edged sword for discretionary trusts. Setting one up may reduce the IHT on your own estate but, in a number of situations, a discretionary trust will be taxed as its own separate entity – which means the trust will have to pay tax on the assets it contains. More information is provided below, but it is important to be aware that discretionary trusts can save tax in some ways and incur it in others.

How are discretionary trusts taxed?

Special rates of tax apply to discretionary trusts. This is because most of them will fall into what is known as the ‘relevant property regime’.

The following sections focus on IHT, which can be quite complicated. If you would like more information on how IHT operates in general, please read our separate help guide on [‘Reducing your Inheritance Tax’](#) or get in touch with us.

There are three elements to the way in which IHT is charged on ‘relevant property’ trusts:

1 An entry charge

If you make a gift during your lifetime into a discretionary trust, and the amount of that gift exceeds the ‘nil rate band’ (currently £325,000), then you will have to pay lifetime IHT at 20% on the amount above the nil rate band threshold. For example, a £330,000 gift would mean that £5,000 would be taxed at 20%. Also, if you’ve made any other gifts or

transfers in the preceding seven years, these will be considered and will reduce the available nil rate band.

If you make a transfer into a discretionary trust and die within seven years, any lifetime IHT charge will be recalculated at the death rate, with credit for any tax you have already paid. There is also a partial tax relief, called 'taper relief', which reduces the amount of the transfer which is taxable. This begins from three years after the transfer was made and the relief increases the more years that pass.

If you create a discretionary trust in your Will, the value of the assets going into the trust will be included in your IHT assessment on your estate. IHT is taxed at a higher rate of 40% upon death, however, there may be additional exemptions and reliefs which can be used to reduce the amount that your estate must pay.

Aside from these entry charges, assets contained within a relevant property regime trust at the time of your death will not be considered a part of your estate. As such they will not affect the IHT calculated on your estate upon death, except in the ways described above.

2 A ten-year anniversary (periodic) charge

This is a charge on the value of the trust fund every ten years from the date of the trust's creation. The maximum tax rate for these charges is 6% and is payable by the trustees (from the trust).

The ten-year periods 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 period.

Most trust assets such as money, shares, houses or land are considered relevant property. There are only very limited circumstances in which an asset will not be classed as relevant property, for example, if it is in a life interest trust ([see our separate help guide for more information](#)), or it is an asset set aside for a bereaved minor or a disabled person.

3 An exit (proportionate) charge

When trustees distribute assets to the beneficiaries, an exit charge is applied over the reduction in value to the trust fund. The exit charge can also occur when some of the assets stop being subject to the relevant property regime – perhaps where they are moved into a different type of trust.

The exit charge is proportional to the number of quarter years that have passed in the current ten-year period.

Including a discretionary trust in your Will

If you create a discretionary trust in the terms of your Will, then you'll probably hear it referred to as a 'Will trust', although any type of trust can be a Will trust if it's created in a Will.

It is possible for discretionary Will trusts to avoid taxation under the relevant property regime. Any distributions made within the first two years after a person's death do not incur exit charges, as these distributions are treated as if they were made in the person's Will. This means that if your trustees decided, after your death, that running the trust was not in the best interests of the beneficiaries, they could wind up the trust and distribute all of the assets to the beneficiaries. Provided this was all done within two years, there would be no charges to the trust through the relevant property regime.

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. This would not count as 'relevant property' (see boxout above) and so would not be taxed under the relevant property regime.

How Roche Legal can help

Dealing with legal issues can be confusing and stressful. We understand this, and we're always on hand to untangle jargon and offer support.

If you need advice on any of the issues raised in this help guide, please don't hesitate to [get in touch](#). Roche Legal is an award-winning legal practice, offering practical and caring advice.

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