



Discretionary trusts

Introduction

This article explains how a discretionary trust works and why you should consider a discretionary trust as part of your Will and last testimony.

Trustees can hold money and property either at their discretion as to distribution of capital and income, or on behalf of some specified beneficiary, either outright, or subject to a condition, such as the attainment of a particular age. The first is a "discretionary trust". The second is an "interest in possession" trust, even while the condition remains unsatisfied.

In law, a beneficiary can demand to be paid his entitlement immediately the trust conditions are satisfied, or at age 18 if none are specified. However, legal actions to enforce this are few and far between. Eighteen year olds are not likely to sue a trustee aunt or parent!

What is a trust?

A trust fund is property (e.g., money or securities) which is held legally by one party (the legal owner) for the benefit of another party (the equitable owner). The legal owner, or trustee, has the right of possession and the right of use of the property, but must exercise those rights to the benefit of the equitable owner, or beneficiary. Trust funds are usually set up principally for family settlements and for charity. In the commercial sector, trust funds are often set up to provide for employee pensions and profit-sharing programs.

What is a discretionary trust?

A discretionary trust is like any trust; however, it is much more flexible.

The trustees of the trust own the trust's property on behalf of the beneficiaries. The beneficiaries need not all even be born at the time the trust is created.

The trustees can pay out income or capital to any one or more of the beneficiaries entirely at their own discretion. No beneficiary has a right to demand income from a discretionary trust.

How do I provide for the survivor?

The surviving spouse or civil partner can be included as one of the beneficiaries of the trust. The trustees can be empowered to pay out income or the underlying capital to the surviving spouse or civil partner at their discretion. Thus the surviving spouse or civil partner can enjoy both the income and capital of the trust. However, with this kind of trust (unlike life interest trusts) the capital is not added to the estate of the surviving spouse or civil partner on his or her death and is not charged to inheritance tax on that occasion.

How can I best guide the trustees after my death?

The best way to guide a trustee after you have died is to leave a 'letter of wishes' with the will. A 'letter of wishes' is read alongside the will, though it is not binding on the trustees. It is quite normal for to state that the primary aim for the trust is to ensure adequate provision is made for the surviving spouse or civil partner for the remainder of his or her life. The letter will also states what should happen to the money after the spouse's death – most like the assets to be passed to their children.

How does the trust operate?

The executors will pass the assets which are to be the trust property to the trustees. Very often, the trustees are the same people as the executors. In this case, they simply own the property as trustees as opposed to holding it as executors.



The trustees will then need to register the trust with [HM Revenue & Customs \(HMRC\)](#) who will send a short form for the trustees to complete. This enables HMRC to register the trust.

Is the trust subject to tax in the normal way?

Yes, the trustees are subject to income and capital gains tax in the same way as individuals. After a deduction for the trust's management expenses, the trust income is taxed at 40% (32.5% for dividends). In addition, capital gains are also taxed at a flat rate of 40% after deducting the trustees' annual exemption which is, at most, half that of an individual.

The trustees will receive a tax return in exactly the same way as an individual. The filing deadlines and the dates for the payment of tax are exactly the same as for individuals.

Distributions of income to beneficiaries, including the surviving spouse or civil partner, will suffer income tax in the hands of the beneficiary but with a credit for the tax paid by the trustees. To the extent that the tax paid by the trustees exceeds the income tax liability arising to the beneficiary on such income, a tax refund will be made to the beneficiary.

Capital can be appointed to beneficiaries tax free in all but exceptional circumstances.

A discretionary trust is subject to inheritance tax every 10 years after the creation of the trust. The rate at which the tax is paid at current rates is not more than 6% of the market value of the trust's assets at the time of the charge and a nil rate discretionary trust will often escape tax altogether.

There is also a charge when assets cease to be held on discretionary trust, e.g. if assets pass out of trust to a beneficiary. In this case, the charge to inheritance tax is based on:

- the value of the property leaving the trust
- the proportion of the period of 10 years for which the assets have been held on discretionary trust since the last 10 year charge
- the rate of tax at the last 10 yearly charge

but subject to any inheritance tax reliefs available at the time.

Who should I nominate as trustees?

This is a very personal decision. Essentially, you will probably want to choose trusted family members or close friends. You should check that the people you nominate are willing to act for you. You might also wish to include a professional trustee, though this may be dependent on the complexity of your affairs.

Trusts and wills are often written on very flexible terms allowing trustees greater discretion in their management. The increasing complexity of modern trust and tax law as well as the reluctance of many people to become involved in decisions that require not only a professional competence but also an independent detachment from family dynamics means that an independent trust company may be the best choice - especially as the trust company is always there and doesn't die, retire or take holidays.

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What sort of property should be included in the trust?

In many instances, it will not matter what property is included in the trust. However, where a person holds business or agricultural property, significant tax advantages can be obtained in structuring legacies between the trust and a surviving spouse or civil partner and further tax planning advice should be sought. Further advice should also be sought where all or part of the nil rate band legacy will need to be satisfied by a transfer of the family home, as additional structuring will be required to ensure that the planning remains effective.

Advantages of a discretionary trust

These are possible advantages:

- to prevent a spendthrift from having access to all of the capital at once. A “spendthrift” may simply be a young person who has never previously had access to a large sum of money.
- to prevent a large amount of cash falling into the hands of an ex-spouse, through the divorce courts. Because there is no interest in possession, a beneficiary cannot be said to “own” any part of the fund. Accordingly, none of it can pass to an ex- spouse (or trustee in bankruptcy). However, the divorce judge, in considering the division of other assets, will take account in broad terms of the likelihood of the beneficiary receiving a distribution in the future.
- to provide flexibility and freedom to the trustees to use the money in what they see as the best interests of the children. Capital can be distributed over many years.

. . . And possible disadvantages:

- trusts are no longer subject to the tax advantages of former years. Successive chancellors tighten the tax net. You must take professional financial advice on how a trust will be taxed before you set it up. However, it is unlikely that tax will ever be greater than that payable by a higher rate tax payer.

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