



DISCRETIONARY TRUSTS

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What is a Discretionary Trust?

A discretionary trust (or settlement) is a special type of trust which holds assets such as land or investments under the control of trustees. The assets (“the Trust Property”) are then used for the benefit of a group of beneficiaries.

The trust is usually established by an individual (“the Settlor”) during lifetime or under the terms of his or her will. By transferring property into the control of the trustees, they then hold the property in accordance with the instructions given to them by the Settlor. The rules are normally set out in a document known as a trust deed or if the trust is established on death the trust deed is the will itself.

The distinguishing feature of a discretionary trust is that there are a group of “potential” beneficiaries. Each beneficiary can receive benefit from the trust, but no beneficiary can insist that the trustees pass any benefit to him or her at any particular time. The trustees have control over the assets and can ensure that the trust property is used for the benefit of one or more beneficiaries. This is particularly useful where the Settlor is not sure which particular members of the family should receive the property, especially whilst they are under age, or perhaps going through an unstable period during their lives. The essence of putting property into trust is the retention of control over the destination of those assets by the trustees.

Once the property is passed into the trust the legal title to that property is in the hands of the trustees. The trust has its own existence for tax purposes.

Assets in a trust may be considered in the divorce or separation of a beneficiary. Assets will be protected from inclusion in assessment for means tested benefits or care charges. If you have any concerns then you may wish to avoid using a trust.

Taxation during the lifetime of a Discretionary Trust

Inheritance Tax (IHT)

IHT is charged:

- ❶ When capital is taken out of the discretionary trust; and
- ❷ Every ten years.

The rate of tax payable when funds are taken out of a discretionary trust depends upon whether the discretionary trust suffered IHT when it was created, or whether IHT was paid on a tenth anniversary of the trust. If there was no tax payable when the trust was created less than ten years previously, or no tax payable on the previous tenth anniversary then there will be no tax paid on taking assets out of the trust.

If there is a charge to IHT then it will be a proportion of the rate of tax charged when the trust was created or on the previous tenth anniversary (if later). The maximum rate of charge is 6%, and is usually less.

On every tenth anniversary there is an IHT charge on the value of the trust fund, to the extent that the value of the fund exceeds the prevailing nil rate band. The maximum charge to tax is 6% of the fund and is only chargeable on the value of the fund in excess of £325,000.

Capital Gains Tax (CGT)

The charge to CGT in the hands of the trustees is at 28% of the chargeable gain. The trustees have an annual allowance (£5,550 for 2015/16) against chargeable gains arising in any one tax year. (The allowance may be reduced if the Settlor has more than one settlement).

Income Tax

As the trust has its own existence for tax purposes the income arising in the hands of the trustees is charged to tax. The trustees are liable to pay tax at 50% on the income. If the trustees distribute the income to a beneficiary he or she will receive a credit for the tax paid by the trustees. The beneficiary may be able to claim a repayment of tax if he is a basic or lower rate taxpayer.

Miscellaneous

- ⑦ A discretionary trust can be brought to an end at any time but cannot last more than one hundred and twenty-five years.
- ⑦ It is usual for the Settlor to give the trustees a letter of his wishes, setting out how he envisages the trust is to be managed.
- ⑦ It is essential that the Settlor and any spouse of the Settlor is excluded from any benefit under the settlement. Otherwise there will be a reservation of benefit to the Settlor and the transfer will be an ineffective gift for IHT purposes. However, the Settlor's widow or widower can be a beneficiary without infringing this rule.
- ⑦ In most circumstances the Settlor or the spouse of the Settlor may be one of the trustees of the trust.

Trusts can seem daunting and complicated but they don't have to be. They are not suitable for everyone but in the right circumstances they have real benefits. Individual advice is essential to ensure they are right for you.

Call us for more information, advice or support – it's what we do:

T: 01227 700 702

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The information contained in this document provides background information only and should not be relied upon as an exhaustive list of the legal issues involved.

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