

Discretionary Will Trusts

Will based trusts are an important tool when it comes to estate planning, so understanding of the benefits of each trust and how they operate is key. This month's CPD will focus on the uses, benefits and taxation of discretionary trusts as well as disabled discretionary trusts.

WHAT IS A TRUST?

In its simplest terms a trust is a legal arrangement whereby property is transferred to one or more people (the trustees) to be held by them for the benefit of one or more persons (the beneficiaries) who may also be the trustees. It is the separation of legal and equitable interests; the trustees hold the legal title to the property but the beneficiaries have the enjoyment of it.

For a trust to exist the three certainties must be present. There must be certainty of intention, certainty of objects, and certainty of subject matter. Certainty of intention is the intention to create the trust. For there to be certainty of subject matter the trust property must be easily identifiable. For there to be certainty of objects the beneficiaries of the trust must be clearly identified.

The trustees are responsible for controlling and managing the trust property for the benefit of the beneficiaries, giving rise to a fiduciary relationship.

The beneficiaries are entitled to enforce the trust by compelling its due administration, through court action if necessary, and may sue the trustees for any breach of trust. They are also entitled to terminate the trust by directing the trustees to transfer the legal title to them provided they are mentally capable, not minors and absolutely entitled to the trust property. This was established in the case of *Saunders v Vautier* [1841] Cr & Ph 240, CA. With discretionary trusts this may not always be possible as members of the class of beneficiaries may be minors or unborn.

WHAT IS A DISCRETIONARY TRUST?

A discretionary trust is a trust where the trustees are given discretion as to how income and capital of the trust fund should be distributed. They have control over how much to distribute at any given time, when to make distributions and who to make them to within a class of beneficiaries chosen by the testator. The trustees must consider exercising their discretion when necessary, but failure to do so does not extinguish their discretionary powers.

The beneficiaries of the trust have no interest in the trust fund unless an appointment is made in their favour. They have only a *spes* or mere hope that the trustees will exercise their discretion in their favour. The beneficiaries do have a right to at least be considered by the trustees, so a beneficiary cannot be deliberately ignored by the trustees.

Discretionary trusts require multiple beneficiaries; either individuals or classes i.e. "my children".

The maximum length of time these types of trust can run for is 125 years. This perpetuity period was extended from 80 years by the Accumulations and Perpetuities Act 2009, at the same time that the accumulation period of income was extended from 21 years to the full duration of the trust.

WHY USE A DISCRETIONARY TRUST?

The main reasons for using a discretionary trust can be split into two categories; tax and non-tax reasons.

Tax Reasons for Using a Discretionary Trust:

- The trust fund is not owned by any of the discretionary beneficiaries and is not counted as part of their estate for Inheritance Tax (IHT) purposes on their death. This is unlike an IPDI trust where the assets in the trust are treated as part of the beneficiary's estate.
- The trust fund is treated as an entirely separate entity for tax purposes.
- IHT is paid periodically at 10 year anniversaries and when property leaves the trust between 10 year anniversaries.
- The trust won't pay IHT where the trust is below the nil rate band (currently £325,000).
- Where IHT anniversary and exit charges are due the current maximum rate the trust will pay is 6%.
- No IHT is payable for 10 years when the initial trust property is less than the testator's available nil rate sum;
- They offer an additional 2 years of flexibility. An appointment made out of a discretionary trust made by Will within 2 years of the testator's death is 'read back' into the Will under section 144 of the Inheritance Tax Act 1984 and treated as a disposition made by the deceased's Will. Using this the Residential Nil Rate Band (RNRB) can be claimed in certain circumstances.
- The trust can make loans to a beneficiary rather than giving them assets outright. This can be beneficial to the beneficiary as on their death any loans must be repaid to the trust, reducing their own IHT liability.

Non-Tax Reasons for Using a Discretionary Trust:

- Flexibility. The trustees can adapt the payments they make and to who depending on each beneficiary's own circumstances and can cater for their changing needs.
- The trustees can defer a beneficiary's entitlement to a certain age. Especially useful where the testator wishes to defer a child's entitlement past 25 so a Bereaved Young Person's Trust wouldn't be appropriate.
- The trust can protect a beneficiary. The trustees could change how they provide for a beneficiary with drug or alcohol problems, who is going through divorce or bankruptcy or who is otherwise unable to manage their own finances.
- The beneficiaries have no right to the trust fund, only a hope that the trustees will exercise their discretion in their favour.
- Assets in the trust are not taken into account for any means tests for benefits or care home fees, but obviously care must be taken when advancing sums to the beneficiary as this may then be taken into account.

- The trust avoids granting any beneficiaries a right of occupation as an interest in possession trust would. The trustees may grant a beneficiary a license to occupy any trust property at their discretion.
- The trust can provide a mechanism to care for a disabled or vulnerable beneficiary, although a disabled person's trust may be more appropriate (this will be covered later in the notes).

While it is totally up to the trustees own discretion how they go about making distributions, the testator can leave a letter of wishes to guide the trustees. This letter cannot be legally binding, but the trustees should consider it when making distributions.

Beneficiaries of a discretionary trust are entitled to see trust accounts and the trustees aren't bound to explain to the beneficiaries why they have exercised their discretion a certain way. The beneficiaries are not entitled to see a copy of the letter of wishes as it is not a document that is integral to the trust (*Re Londonderry's Settlement* [1965] Ch 918).

TAXATION

Discretionary trusts are relevant property settlements and taxed subject to the relevant property regime.

Inheritance Tax

Inheritance tax is paid in the usual way on the testator's death if their estate exceeds available nil rate bands. The value of the property that passes to the trust is treated as the commencement value of the trust.

On the death of a discretionary beneficiary the trust fund is not included in their estate for IHT purposes. So instead HMRC tax the trust itself.

If the value of the assets in the trust are above the NRB of £325,000 then the trust may suffer anniversary and exit charges.

On each of the trusts 10 year anniversaries the trust fund is revalued. If the trust exceeds the NRB then there will be an anniversary charge of a max of 6% on the value of the assets over the NRB.

When the trustees distribute the trust fund or when they wind up the trust there may be an exit charge. The rate of the exit charge is a proportion of the anniversary charge, calculated by reference to the number of complete 3 month periods, either from the last anniversary or from commencement if there has not yet been an anniversary. Again, the max charge will be 6%.

Income Tax

Income up to £1000 is taxed at the basic rate of 20% for ordinary income, or 7.5% for income from dividends.

Income above £1000 is taxed at the higher trust rate of 45%, or 38.1% for dividends.

When the trustees make payments out of income to beneficiaries they must provide them a certificate of tax deducted, known as form R185, which will show a tax credit of 45%. If the beneficiary is not a tax payer or pays income tax at a lower rate then they may claim the tax back (unless it is dividend income).

Capital Gains Tax

For CGT purposes the trustees of a discretionary trust have an annual allowance of half that of an individual. Currently £5650 (2017/18).

The trustees are deemed to acquire the trust property at its probate value.

CGT may become due on actual disposals and deemed disposals. If the trustees make an actual disposal (selling trust property) then CGT will be due on the difference between the sale price and the acquisition price. Trustees make a deemed disposal for CGT purposes when a beneficiary becomes absolutely entitled to trust property; the CGT will be due on the difference between the market value of the trust property when the disposal is made and the acquisition value.

Trustees will pay CGT at a rate of 20% on disposals of assets that are not residential property. If trustees dispose of residential property that does not qualify for private residence relief then they will pay CGT at a rate of 28%.

Where the disposal is a chargeable transfer for IHT purposes holdover relief may be available. Holdover relief defers the payment of CGT so that it is borne by the recipient of the gift.

Example:

Terry transfers his house to a discretionary trust. When he bought it the property was worth £100,000. At the time of the transfer it is worth £125,000, so there is a £25,000 gain on which he can be taxed.

As a transfer to a relevant property settlement this is a chargeable transfer for IHT purposes holdover relief is available. Terry claims holdover relief and pays no CGT on the transfer. The trust acquires the property with the base value of £100,000. When the trust disposes of the property it will pay CGT on the difference between the price when the trust disposes of it and the base value when the trust acquired it.

Without holdover relief Terry would have paid CGT when the property was transferred into trust, the trust would have acquired the property at the market value (£125,000) and when it disposed of it the CGT would be paid on the difference between the base value at acquisition and the value when disposed of.

DISABLED PERSONS TRUSTS

Where a testator wishes to provide for a beneficiary who is disabled they may wish to consider leaving assets on trusts that satisfy the requirements of section 89 of the Inheritance Tax Act 1984. A disabled person's trust is a form of discretionary trust that makes special provision for a disabled beneficiary and receives favourable tax treatment. The trust itself and the beneficiary must meet certain requirements for the trust to receive special treatment.

To qualify for this type of settlement the principal beneficiary must meet the definition of 'disabled' which is held in section 38 of the Finance Act 2005. For the purposes of this trust a 'disabled person' is a person who:

- by reason of 'mental disorder' within the meaning of the Mental Health Act 1983 is incapable of administering his property or managing his affairs,
- is in receipt of attendance allowance,

- is in receipt of a disability living allowance by virtue of entitlement to the care component at the highest or middle rate, or the mobility payment at the higher rate,
- is in receipt of personal independence payment,
- is in receipt of an increased disablement pension,
- is in receipt of constant attendance allowance, or
- is in receipt of an armed forces independence payment.

For a trust created on or after 8 April 2013 to qualify it must meet the requirements of section 89 IHTA 1984, which were amended by the Finance Act 2013:

- During the lifetime of the disabled person there must be no entitlement to income
- If any of the settled property or income arising from it is applied during the disabled person's life it must be applied to or for the benefit of the disabled person.
 - This doesn't mean that other beneficiaries can't benefit from the trust. If the trustees have the appropriate powers they may make payments to other beneficiaries and still be treated as meeting the section 89 requirements. These payments must be within an annual limit of whichever is the lower of £3000 or 3% of the trust fund. This limit is shared between all of the non-principal beneficiaries.

The result is that the trust is effectively a discretionary trust, but the disabled person is treated as having a deemed interest in possession so the trust is not subject to the relevant property regime while the disabled person is alive.

As the trust is discretionary the trustees are not obliged to distribute anything to the disabled beneficiary or any of the other discretionary beneficiaries. The disabled person does not have any entitlement to income or capital, but they are assured that anything that *is* distributed must be for their benefit (subject to the annual limit).

As the trust is discretionary the assets are not taken into account for means tested benefits, so any benefits the disabled person is entitled to will not be affected. Obviously the trustees must still be careful in how they manage the fund and should avoid advancing large amounts to them as once assets are in their estate they may be assessed.

After the disabled person's death the trust may carry on as an ordinary discretionary trust, in which case the usual taxation rules will apply, or the remaining property can be left to other beneficiaries absolutely.

TAXATION

Although discretionary in nature trusts satisfying the requirements of s89 receive favourable tax treatment.

Inheritance Tax

Inheritance tax is paid in the usual way on the testator's death if their estate exceeds available nil rate bands. The value of the property that passes to the trust is treated as the commencement value of the trust.

During the life of the disabled person the trust is not subject to IHT anniversary and exit charges, provided the trustees stay within their annual limit if distributing to other beneficiaries.

On the death of the disabled person the trust fund is revalued and the value of the trust fund is aggregated with their free estate for IHT purposes.

Income Tax and Capital Gains Tax

The trustees and disabled person can make a 'vulnerable person election' to apply for special income tax and CGT treatment. They must do this by completing a vulnerable person election form (VPE1). This will then allow the trustees to decide each year if they wish to apply the special tax treatment. The election must be made no later than 12 months after 31 January following the tax year when it is to start.

Where the special tax treatment is applied the trustees must work out the tax as follows:

Income tax:

- the trustees calculate their income tax liability on the normal basis as though there was no claim for special treatment
- they then calculate the income tax the vulnerable beneficiary would have had to pay if the trust income had been paid directly to them as an individual
- the trustees then claim the difference between these two figures as a deduction from their own income tax liability

Capital Gains Tax:

- the trustees calculate the CGT as if there was no claim for special treatment
- the trustees then calculate the CGT as if the gains arose directly to the vulnerable beneficiary
- the trustees then claim the difference between these two figures as a deduction from their own CGT liability.

CONCLUSION

Discretionary trusts are a useful estate planning tool for many clients, whether their concerns are protecting their assets for their children who are vulnerable or who cannot be trusted to manage their own inheritance responsibly, or whether they wish to keep assets out of their beneficiaries' estates so as not to increase their tax liability.