AWFM Fact File

"Discretionary Trusts"

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Discretionary Trusts are most often used to reduce liability to Inheritance Tax (IHT) in a perfectly legitimate manner. The term "Discretionary" means that the ultimate beneficiaries of the Trust are not fixed at outset (as with a Bare Trust) – instead they can be altered at the *discretion* of the Trustees. This makes them useful for people who wish to give assets away but are not totally clear on who should receive the funds.

Understanding the tax treatment of Trusts is vitally important, to ensure that the right decisions are made. Different tax rules apply to a Trust for a disabled/vulnerable person and a Bare Trust which are briefly mentioned at the end of this Fact-File. Here we focus on Discretionary Trusts.

Gifting Funds into a Discretionary Trust

- Gifts into a Discretionary Trust are known as Chargeable Lifetime Transfers (CLT).
- If the gift into the Discretionary Trust takes the donor's seven-year cumulation over the nil rate band, IHT of 20% is paid on the establishment of the Trust.
- If the gift keeps the donor's seven-year cumulation below the nil rate band, there is no immediate IHT to pay.

Death of the Donor

- If the donor survives for 7 years after making the CLT, there will be no further IHT to pay on the death of the donor.
- If the donor dies within 7 years of making the gift, tax at the death rates will apply retrospectively to that transfer. The tax is recalculated using the value of the gift and the previous seven-years' cumulation at the date of the transfer, but using death tax rates in force at the date of death. A credit is allowed where a CLT tax was paid at the time of the transfer (currently 20%). The tax is reduced by taper relief if the donor survives for more than 3 years from the date of the transfer.

Income Tax within the Trust

- Income within the trust is generated (whether or not it is paid out) because of the Dividends on Shares and the Interest/Coupon paid on Fixed Interest stocks. A Discretionary Trust has a "standard rate" income band of £1,000 normally.
- Gross income that falls within the first £1,000 for each trust will be taxed at either 10% or 20% depending on its source.
- This £1,000 needs to be shared equally between the number of Trusts created by the donor. If the donor created three separate Trusts, each Trust fund has a "standard rate" income band of £333.
- Thereafter, 50% income tax is payable on income other than Dividends deducting any tax paid at source.
- Income tax of 42.5% is payable in Dividend income received into the Trust.

Income paid out to a potential beneficiary of the Trust does carry a 50% tax credit which can then be used to potentially claim back some of the tax initially paid out by the Trust:

- A non-tax paying beneficiary may be able to reclaim all of the tax deducted by the Trust.
- A basic rate tax paying beneficiary is taxed at 20% normally and is therefore entitled to reclaim the excess 30% tax paid by the Trust.
- A higher rate tax paying beneficiary at the 40% level can reclaim the additional 10% tax credit.

Such tax reclaims would be carried out by the beneficiary completing an annual self-assessment tax return. It should also be noted that the Trust itself has to complete an annual self-assessment form which may well incur an annual fee from an Accountant, increasing overall running costs of the Trust.

Capital Gains Tax (CGT)

- CGT is payable on capital gains that are crystallised from investments within the Trust.
- Individuals and Trusts have an annual allowance of capital gains within which no CGT is payable.
- The annual CGT free allowance for trusts is £5,300 (half the individuals' allowance).
- However, again this annual allowance is then divided by the number of Trusts created by the settlor.

The tax payable on gains in excess of the annual allowance is 28% for 2012/13. On the whole CGT is worse for Trusts than it is for individuals as there is a lower tax free allowance and potentially higher rate of tax, particularly for a non or basic rate tax payer. It is not possible to reclaim any of the CGT paid out by a Trust.

IHT Periodic & Exit Charges for Trusts

The final set of taxes are peculiar to Trusts and apply to Discretionary Trusts in particular:

- The *Exit Charge* is applied when a part of the Trust or all of the Trust funds are distributed to beneficiaries. Income payments are disregarded for Exit charge purposes. The tax is 30% of the lifetime rate (20%) which equates to a current tax charge of 6%. However only x/40ths of the full tax is charged, with x being the number of full 3 month periods during the 10 year period. So if £100,000 were distributed at the start of the 6th year, an exit tax charge of £3,000 would be applied (£100,000 x 6% x 20/40).
- The *Periodic Charge* is 30% of the lifetime rate (20%) which equates to the same 6% of the value of the Trust fund but only the amount which is in excess of the current Nil Rate Band at the time of the transfer. It is payable every 10 years.

Other Types of Trust

Bare Trusts are trusts where the beneficiaries are fixed at the outset and cannot be altered. A Bare Trust exists where the trustees act on behalf of the beneficiaries. Broadly speaking any tax due within the Trust (Income or Capital Gains) is treated as belonging to the beneficiary. Gifts into a Bare Trust are a Potentially Exempt Transfer (PET) initiating the seven-year survival rules. The caveat to Bare Trusts' tax treatment is where parents make the gift. In this case, the income will be added to the parents' income and taxed at their marginal rate.

Trusts for Vulnerable Beneficiaries will tax the income and gains from the trust based on the tax position of the beneficiary so that parents can set aside funds for children without adverse tax consequences.

Summary

The use of Trusts can be complicated and costly however they can be very useful in certain circumstances to help deal with a particular problem. It is clear that in trying to mitigate one type of tax it is possible to fall into a less advantageous different tax regime. Specialist impartial advice is recommended.

If you have any questions or need an independent review of your financial planning, pension or trust arrangements, please contact us to discuss your situation further. AW Financial Management LLP is an Independent Financial Adviser regulated by the Financial Conduct Authority.

Information given in this document should not be taken as advice as it is intended for guidance only. If you wish to have an assessment of your own situation, you should contact the office for advice.