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Discretionary Trusts

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DISCRETIONARY TRUSTS

A discretionary trust is one whereby the person creating the trust (normally called “the settlor” but where the trust arises under a Will may also be referred to as “the Testator”), creates it in favour of a group of people (lawyers normally refer to these people as “the class of beneficiaries”. These people may or may not be related. The Trustees of the Trust are then given the discretion to determine how much (if anything) different members of the class of beneficiaries is to receive and how they should receive it. This trusts can be created either during that person’s lifetime or on their death through their Will.

The person creating the trust cannot determine in advance the precise extent of each beneficiary’s entitlement, that is left to the Trustees discretion. The Trustees decisions on any matter from the investments used for the trust funds to the payment out to a beneficiary must be unanimous. If the settlor wishes to allow the Trustees to decide by way of a majority decision then specific powers must be given through the Trust Deed.

A discretionary trust is therefore a flexible method of giving, as the gift can be adapted according to changing circumstances. For instance, certain beneficiaries can be protected from their own immaturity through the Trustees powers to make regular small payments to or on behalf of a beneficiary as well as lump sums, or to place funds into a separate specialised trust. In some instances they may decide not to make any payments to a beneficiary.

Alternatively, a testator may have most of his assets tied up in a business and, while he would like an equal division of his assets between his children, he does not want the business to be sold or parts of it hived off and lost. He may, therefore, wish to transfer the business to trustees and give his trustees power to run the business on behalf of his children and provide them with sufficient flexibility to decide the best course of action in the light of circumstances prevailing at any future time.

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Because payments out of a discretionary trust are at the Trustees discretion, the beneficiaries of a such a trust do not have a right to enjoy any of the trust assets, they only have a hope of doing so. However, a beneficiary who takes trust property instead of a monetary payment does have a right to benefit from that asset, subject to the failure of the discretionary trust.

- The discretionary trust allows trustees to dictate whether to distribute or withhold income, thereby distributing income in a year when a beneficiary's total income is low and consequently total tax liability is low.
- Trustees can, for limited periods, postpone any distribution, thereby converting the income into capital.
- Trustees can distribute the income widely amongst a group rather than bunching the whole into the hands of one person. This can have the effect of reducing the tax rate on a number of persons (e.g. at lower rate) rather than the one person paying a higher rate on significant amounts.
- Savings in capital gains tax and inheritance tax can also be achieved through the use of the discretionary trust.

Discretionary Trusts and gifts are taxed:

Inheritance Tax – Where this type of trust is created under a Will, on the death of the testator his estate will have been subject to Inheritance Tax (if applicable) and this will have been paid before the trust fund is paid to the Trustees. However, if the trust is created during the settlor's lifetime the value gifted into the trust may subject to an Inheritance Tax charge of half the death rate immediately. The gift remains at risk for a further Inheritance Tax charge if the settler dies within 7 years of making the gift.

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Where the value of a discretionary trust fund exceeds the nil rate band threshold, a 10 year “anniversary” tax charge is made. This usually equates to approximately 6% of the value over the threshold. In addition, when the trust fund is distributed an “exit” charge may be levied.

Income Tax – Trustees pay income tax at the higher rate on all income received into the trust fund and they do not have a personal allowance.

Capital Gains Tax – Trustees pay capital Gains tax at 18% and only have half the annual allowance.

Certain aspects of a discretionary are outlined below:

- The choice of the trustee
- The perpetuity period
- Certainty of objects
- The discretionary trusts of income and capital
- Default trusts

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Administration – trustee selection

Because of the considerable discretionary powers given to the trustee, the person creating the trust must take particular care in his choice of Trustee or Trustees. The settlor must be confident that the person or people he chooses have the knowledge, experience and common sense to administer the trust correctly and in a manner that he would approve. It is also essential that the Trustees are people who get along well or can at the very least co-operate with each other. It is also wise to consider whether the discretion given to a trustee puts him or her in a position where there is a conflict of interest. For example while it is common for one or more of the beneficiaries to be trustees this may not be wise if the Trustee/Beneficiary has financial problems. The trustee must, therefore, be aware of the settlor's intentions behind the trust and wishes for its administration and distribution.

In lifetime trusts it is sometime possible for the Settlor to set up arrangements which give him some say in the Trustees decisions but this is something which has to be done with considerable care.

With trusts arising under a will it is common for the Testator to provide the trustees with some assistance and guidance in deciding whether and how to exercise their discretions. The guidance frequently takes the form of a letter (or memorandum) of wishes. The Testator may, for instance, set out in a letter how he would prefer the trust to be administered and, in particular, who he would like to benefit, in which circumstances and to what amount.

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The perpetuity period

A trust cannot usually go on forever. The law provides that the normal maximum life of the trust is 80 years but the Trust document can specify a shorter period. The trust has to be brought to an end by the end of this time which is called the “perpetuity period”.

Certainty of objects

The objects of a trust generally mean the beneficiaries and the terms of the trust. While the aim of a discretionary trust is to be flexible this must be within a structure which has certainty failing which the trust may be considered to be void (in other words invalid and ineffective). This is usually achieved by:

- Naming the beneficiaries, or
- Ensuring they are ascertainable by identifying the class by description.

The discretionary trusts of income and capital

A standard trust instrument, creating a discretionary trust, will have separate clauses dealing with the income and the capital of the trust fund.

This enables the trustee to make a simple capital distribution to the chosen beneficiary, with no strings attached. It is sometimes referred to as an “Appointment of an absolute interest” and is usually undertaken by a Deed of Appointment.

However, trustees may be given power to distribute capital with strings attached, namely by creating a new trust in favour of the chosen beneficiary or by modifying the

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terms of the existing trust. This is also usually done by a Deed of Appointment. In some trusts these appointments can also be made by Trustees resolutions

Default trusts

If the trustees have not distributed everything, income and capital, by the end of the trust (perpetuity) period, then the remaining trust property will revert to the settlor.

This would never happen in practice, but the fact that it could happen means that the settlor retains an interest in the trust and its assets, this then brings into play legislation designed to catch tax avoidance and results in the income and capital gains of the trust being taxed as if they were income or capital gains of the settlor. This therefore is a major problem for lifetime trusts.

Accordingly, in order that any undistributed income or capital remaining in the trust at the end of the trust period cannot “revert” back to the settlor, the trust instrument usually contains a clause which states who should receive any residue of the trust fund. This clause is referred to as the “ultimate default trust”. It does not matter whether the default beneficiary is alive at the end of the trust so long as the default trust is worded in such a way that whatever happens that person or his estate will inherit. Sometimes an institution such as a charity is often chosen.

Where trusts are created by Will it is common put in default trusts although they are not essential.

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