Ward Williams
chartered accountants

Your guide to

Discretionary Trusts in Tax Planning

2019-20

The use of Trusts

- Should I make an outright gift or consider making a gift to a trust?
- What are the tax implications of creating a trust?
- Can I name myself as a trustee?
- What type of trust should I create?
- Can the use of a trust help mitigate the IHT on my estate?
- What type of property can I transfer to a trust?
- Aren't trusts only used by wealthy individuals?
- Can the use of trusts help with succession planning?

Using Ward Williams as your Tax Adviser

Ward Williams is a member of the Institute of Chartered Accountants in England and Wales.

As Chartered Accountants you can be confident that we have the specialist knowledge to assist you with your tax affairs.

Ward Williams can help you in a variety of ways:

Tax planning – reviewing your affairs and providing comprehensive trust tax advice, tailored to specific needs, both to the settlor and the trustees during the trust period

Trust registration service – assisting the trustees with registering the trust with HMRC

IHT accounts – preparing IHT accounts in order to disclose chargeable events to HMRC, to include undertaking IHT calculations in regard to principal and exit charges

Trust tax returns – preparation of annual trust tax returns, to include preparing income tax and capital gains tax computations, together with forms R185 on the distribution of trust income

Trust accounts – preparation of trust accounts to meet both the trustees and beneficiaries needs

Will writing – assisting with writing and reviewing Wills, to include advice on Will Trusts

Trusts deeds — assisting with the preparation of trust deeds

What is a trust?

A trust arises where:-

- a person referred to as "the Settlor"
- transfers assets to "Trustees" (appointed by the Settlor)
- for the benefit of others called "beneficiaries"
- for a certain period of time ("the Trust Period")

Why do people use trusts?

An individual with assets at their disposal may be prepared to make absolute gifts of those assets to relatives or friends, as steps towards inheritance tax (IHT) planning. Whilst a direct gift has the benefits of simplicity, there are a number of reasons why an individual may not wish to make outright gifts, such as loss of control and the age or personal/financial circumstances of the donee.

By gifting assets to a trust rather than to an individual outright, a donor is able to remove assets from his estate, thereby triggering the "seven year clock" for IHT purposes (the value of a gift will become exempt from IHT if the donor survives for a period of seven years from the date of the gift), but is able to avoid some of the disadvantages associated with an outright gift.

Trusts have long been used as a means for people to protect their assets and to control their management, as well as determine how those assets are transferred to others and when. Flexibility and tax issues are also important factors which influence an individual's decision for the use of a trust.

• Control

The settlor lays down his motives at the outset and decides the extent of the beneficiaries' interests and the powers available to the trustees, as set out in the terms of the Trust Deed. It is quite acceptable for a settlor to act as a trustee.

Retaining control over the management and ultimate destination of assets is an important reason for using trusts. The settlor is immediately able to divest his ownership of an asset, yet the existence of a trust prevents ownership passing straight to the beneficiaries. By retaining some form of control, the settlor/trustees decide the timing and extent of the beneficiaries' entitlement. Therefore, ownership of trust property can be transferred over a period of time to the next generation, at the settlor's/trustees' discretion.

- ### Protection

The protection element stems from the fact that the assets do not become the property of the beneficiaries but are held by the trustees on behalf of the beneficiaries. The trustees have the responsibility of managing the assets and have a duty to protect and preserve trust property.

A trust is an ideal vehicle for an individual who wishes to remove assets from their estate without passing absolute control and ownership to an intended beneficiary. This can be useful where a donor has concerns over the age of the beneficiaries, possible financial difficulties a beneficiary faces, divorce proceedings or the vulnerability of a beneficiary.

- ### Flexibility

Trusts are quite often intended to run for many years. Flexibility can be useful where the settlor is uncertain as to the precise extent of each beneficiary's entitlement at the time he makes the gift. Trusts are sufficiently flexible to allow for ever changing situations, which is important when the future needs and circumstances of the beneficiaries are not obvious at the outset. An outright gift offers no such flexibility.

- ### Tax considerations

Trusts are a means for passing on wealth and are, therefore, an effective tool for inheritance tax (IHT) planning. With careful planning IHT mitigation can be achieved through the use of trusts, but with the added benefits discussed above.

The direct tax implications of creating a trust are discussed below.

Types of trust

The types of trust are:

- bare trusts
- interest in possession trusts
- discretionary trusts
- accumulation and maintenance trusts
- mixed trusts
- settlor-interested trusts
- vulnerable beneficiary trusts/disabled trusts
- charitable trusts
- non-resident trusts

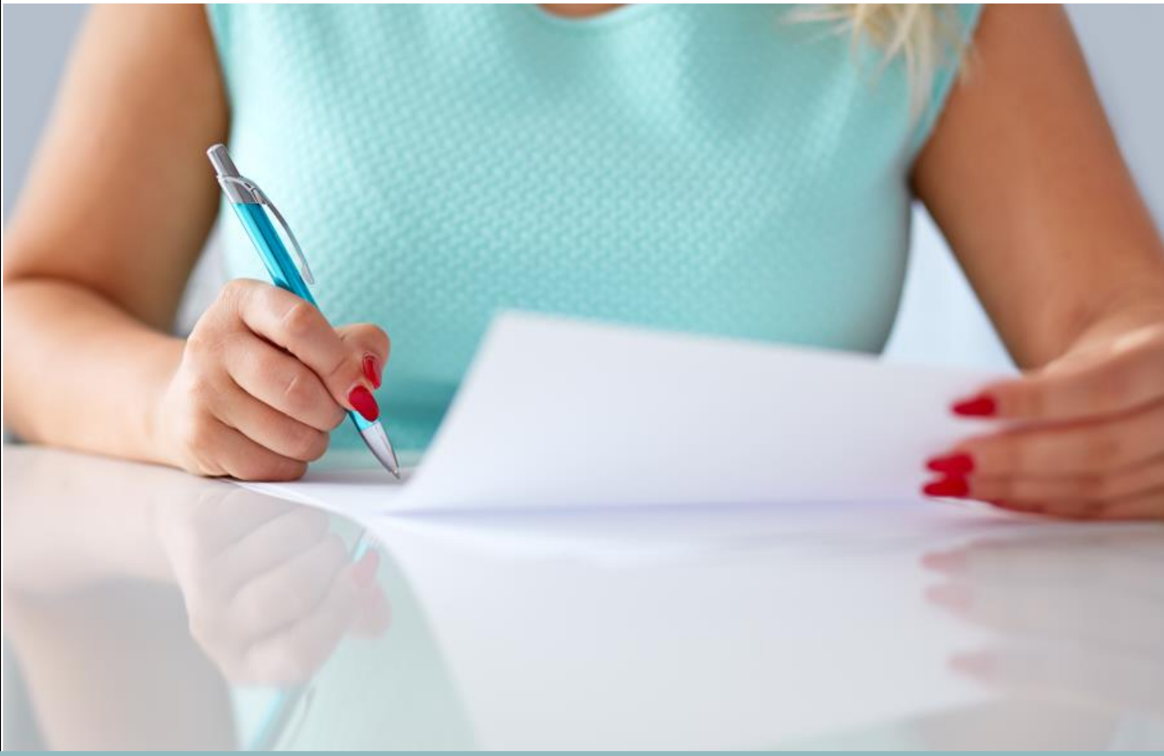
This guide focuses on discretionary trusts, as this type of trust is more commonly used due to the flexibility offered.

What is a discretionary Trust?

A discretionary trust is the most flexible form of trust, often recommended for use in tax planning. The settlor will specify a list of potential beneficiaries or class of beneficiaries who may benefit from the trust funds, but the precise interests of each beneficiary, including that of any future beneficiary, is left to the discretion of the trustees. By specifying a wide class of beneficiaries, the settlor can include future generations, for example, grandchildren born during the trust period.

Under a discretionary trust the beneficiaries have no automatic right to receive any of the trust income or capital. The trustees will have complete discretion as to which beneficiaries will actually benefit, at what time they will benefit and to what extent they will benefit. The trustees will use their discretionary powers to use and distribute the income and capital of the trust entirely at their will. For example, the trustees may decide to distribute only a proportion of the income to one or more class of beneficiaries, or retain and accumulate the whole of the income. Likewise, a decision could be made to advance or appoint all or part of the capital to a beneficiary, or Indirectly by funding a beneficiary's education.

The settlor can give guidance to the trustees in a Letter of Wishes, indicating how he would like the discretion to be exercised, although this will not be binding on the trustees. In practice, however, the settlor may appoint himself as a trustee in order to retain a degree of control and be actively involved in the decision making process.



Tax consequences

Before creating a discretionary trust, it is advisable to consider the tax implications. These are discussed below.

Inheritance tax (IHT)

Lifetime transfers of value, namely gifts, that are immediately chargeable to IHT are referred to as chargeable lifetime transfers. Gifts to discretionary trusts are an example of a chargeable lifetime transfer.

IHT is currently payable at the rate of 40% on any chargeable transfer arising on death and at a reduced rate of 20% on chargeable lifetime transfers. There are, therefore, IHT implications to consider of gifting assets to discretionary trusts.

Provided that the chargeable value of the assets transferred into the trust, together with the value of any other chargeable lifetime transfers made in the preceding seven years, does not exceed the settlor's nil rate band for IHT purposes (for 2019/20 the nil rate band is £325,000) then no IHT liability arises on the settlor on the creation of the trust. If the chargeable value transferred into the trust exceeds the nil rate band, the excess is immediately chargeable on the settlor at 20%. Should the settlor pass away within seven years of the gift, then a further IHT charge arises of 20%, which will be payable by the trustees on the excess.

Illustration—creation of a trust—lifetime IHT charge

Assume a settlor transfers a residential property to a discretionary trust. The property has a market value of £350,000 as at the date of the gift. A gift to a discretionary trust is a chargeable lifetime transfer for IHT purposes. The settlor made no other chargeable transfers in the preceding seven year period. The lifetime IHT charge on the settlor is calculated as follows:

	£
Chargeable lifetime transfer	**350,000**
Less: nil rate band at date of gift	**(325,000)**
Chargeable to IHT	**25,000**
IHT at 20%	**5,000**

Generally speaking, HMRC is not able to impose an IHT charge on a beneficiary of a discretionary trust, and therefore, such IHT charges will be levied on the trustees instead during the trust period. This can arise when assets are transferred out of a trust (exit charge) and at each ten year anniversary of the trust (principal charge).

The principal charge is calculated as a percentage of the value of the trust at each ten year period. This IHT charge cannot exceed 6% of the value of the trust fund.

The exit charge arises when trustees make a capital distribution to a beneficiary. The IHT exit charge is calculated as a percentage of the value of the assets leaving the trust.

Capital gains tax (CGT)

A settlor creates a trust by transferring assets into the trust. Assuming the assets settled are not cash (cash is not a chargeable asset for CGT purposes), the settlor is deemed to have made a disposal at market value for CGT purposes (the settlor and the trustees are connected persons and therefore, all transactions are considered to take place at market value).

Under the gifts relief provisions, a claim to defer a capital gain can be made, where the gift is a chargeable transfer for IHT purposes. If a settlor transfers assets to a discretionary trust, this is a chargeable transfer for these purposes. Therefore, capital gains arising on the gift of any asset to a discretionary trust will qualify for gift relief, and thus the gain can be deferred. Effectively, this simply means that the settlor can defer the CGT payable until the asset is sold or distributed by the trustees at a later date, and at which time, the trustees will then be responsible for the payment of any CGT. This is a useful relief to take advantage of when considering succession planning, as it allows the settlor to avoid an immediate charge to CGT when gifting an asset. An outright gift to an individual will not qualify for gift relief.

Illustration—creation of a trust—gifts hold-over relief

Assume a settlor transfers a residential property to a trust. The property has a market value of £350,000 as at the date of the gift. A gift to a trust is a disposal by the settlor at market value. The property cost say £200,000. The capital gain on settling the property into the trust is:

	£
Market Value	350,000
Less: cost	(200,000)
Gain	150,000

A claim for gift hold-over relief will defer the capital gain of £150,000. In these circumstances the trustees' base cost of the property going forward for CGT purposes will be:

	£
Market Value	350,000
Less: deferred gain	(150,000)
Base cost	200,000

A charge to CGT may also arise during the trust period, if the trustees either sell trust assets or appoint assets out of the trust to a beneficiary (a deemed disposal – see below). A discretionary trust is a separate entity for CGT purposes and has its own exemptions and reliefs. The annual exemption for CGT purposes is one half of the exemption generally available to individuals (£6,000 for 2019/20).

Therefore, if the trustees make a capital gain on settled property, the trustees, as a chargeable person in their own right, will be subject to CGT. Gains realised are subject to CGT at a rate of 20% (28% applies to the sale of residential property).

A deemed disposal occurs when the trustees take the decision to transfer assets out of the trust to a beneficiary. Such a transfer is deemed to take place at the market value of the asset as at the effective transfer date for CGT purposes. Transactions of this nature are also chargeable transfers for IHT purposes. Therefore, on the disposal of an asset to a beneficiary, gift relief will be available to the trustees in the same way as gift relief is available to a settlor (upon creating a trust). A gift relief election would, therefore, defer any gain otherwise chargeable on the trustees, until such time as the beneficiary personally disposes of the asset. It can therefore be seen that gift relief will allow a donor, via a discretionary trust, to pass an asset tax efficiently to a donee over a period of time, without incurring immediate charges to CGT.

Income tax (IT)

Any income generated by the trust assets will be subject to IT and payable by the trustees. The trustees are responsible for registering the trust with HMRC and filing annual trust tax returns. Income is generally taxed within the trust at the 'trust rate' of 45% or the 'dividend trust rate' of 38.1%, according to the type of income.

As mentioned above, the trustees have the power to accumulate or distribute the net income of the trust as they see fit. When a beneficiary receives trust income, it carries a tax credit at the trust rate of 45%, regardless of the nature of the income. As a tax planning point, it should be noted that if income is distributed to a beneficiary whose rate of tax is lower than that of the trustees, then that beneficiary is entitled to make a repayment claim from HMRC for the additional tax paid by the trustees. For example, if the beneficiary pays income tax at say the basic rate of 20%, then the beneficiary could reclaim the additional tax paid by the trustees on any income distributed to the beneficiary from the trust fund. With careful planning, this can be used as a mechanism for clawing back some of the tax paid by the trustees at the higher trust rates of income tax.

Illustration—distribution of trust income

Assume a discretionary trust distributes £5,500 to a beneficiary. The beneficiary has received a net amount of £5,500. Taking into consideration the tax paid by the trustees, the beneficiary is deemed to have received gross trust income of £10,000 from which 45% tax of £4,500 has been deducted at source. If the beneficiary pays tax at 20% or 40%, a tax repayment will be due.

The assets transferred to the trust would cease to be those of the settlor for IT purposes and as mentioned, the higher trust income tax rates will apply. The exception to this is where the discretionary trust might have a class of beneficiaries who constitute the minor children of the settlor. Any income paid to, or applied for, the benefit of those children while they are both unmarried and under the age of 18, will be treated as taxable income of the settlor and not the trustees.

Summary – Tax Consequences

I. On the creation of a trust, the settlor transfers assets to the trustees
II. The transfer of assets into a discretionary trust has IHT and CGT implications on the settlor
III. If the trust assets generate income, or the trustees dispose of assets, during the trust period, the trustees will be subject to trust IT and CGT
IV. If income is distributed to a beneficiary by the trustees of the trust fund, that beneficiary may be in a position to recover the additional trust tax from HMRC
V. If the trustees appoint an asset to a beneficiary, there are IHT (exit charge) and CGT Implications on the trustees
VI. IHT principal charges arise on the trustees on each ten year anniversary of the trust

Conclusion

A trust is an ideal vehicle for an individual who wishes to remove assets from their estate in a tax efficient manner, without passing absolute control and ownership to a beneficiary.

As there are many issues to consider, expert advice should be sought from accountants who specialise in Trusts.

The next step

To arrange a consultation please contact us at **enquiries@wardwilliams.co.uk.** Contact details for each office are on the back page.

Ward Williams Chartered Accountants is fully supported by other divisions within the Ward Williams group: Ward Williams HR and Ward Williams Financial Services. We look forward to hearing from you.

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