

# Tax Overview Discretionary Trust



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This guide is to help you understand the key points of how discretionary trusts arising from wills are taxed and is based on the current 2023/2024 tax year rules and therefore may be subject to change.

Discretionary trusts provide flexibility over how the trust fund is used. Trustees can make decisions based on the circumstances of beneficiaries at the time and can be guided by a letter of wishes.

Managing the legal and tax requirements of a discretionary trust can be complicated. Many trustees will seek professional help with this and pay the expenses from the trust fund.

## **Inheritance Tax (IHT)**

- The starting value is the value of the trust fund received from the deceased's estate.
- If the starting value is less than the Nil Rate Band (currently £325,000) then no exit charges will apply in the first ten years.
- The trust fund will be revalued every ten years and IHT charged up to 6% on the amount exceeding the Nil Rate Band and reliefs at the time.
- When the trustees make payments to beneficiaries, an exit charge may be applied if the value of the trust exceeds the Nil Rate Band. The amount payable will be calculated based on the length of time held in trust since commencement or if after ten-years has passed the most recent ten-year anniversary date.

- Within the first two years of the deceased's death, the trustees may avoid exit charges by utilising s.144 of the Inheritance Tax Act. If the trust contains residential property owned by the deceased, the trustees may choose to appoint out the property to qualifying beneficiaries for the Residence Nil Rate Band to be claimed.
- After this time, trustees may make distributions from the trust fund without an exit charge within the first quarter of every ten-year interval.

### **Capital Gains Tax (CGT)**

- The death of the testator does not create a charge to CGT.
- The trustees receive the trust fund at Probate value – known as the trustees base cost.
- Charges to CGT arise when property or other assets (providing not exempt) are sold or transferred to beneficiaries and where there has been an increase in value above the trustees base cost.
- From 06.04.23, trustees have an annual exempt allowance of £3000. From 06.04.24, this reduces to £1500. If there are multiple trusts, the allowance is shared between them.
- The CGT rate for trustees is 20% and 28% for residential property.

## Income Tax

- On the first £1000 of income received annually, the trustees will pay tax on this at the standard rate of 20% and 8.75% on dividends.
- After this, trust income is taxed at 45% and 39.35% on dividends.
- If the trustees make an income payment, the net amount is passed to the beneficiary. The trustees must keep sufficient funds to pay the tax and issue the beneficiary with an R185 form that can be used in his/her own self-assessment.
- Depending on the beneficiary's income tax rate, he/she may be able to reclaim some or all of the tax paid by the trustees.

## Trust Registration

If the trust still exists two years after death, the trustees must register the trust with HMRC within 90 days. The exception is that if the trust incurs a UK tax liability earlier than the two-year anniversary, it must be registered within 90 days of the tax liability arising.

**Disclaimer.** We hope this provides a useful summary of the current tax position. This is not tax or legal advice and you should always take care to obtain advice relevant to your own situation.

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## How it works in practice

Norma set up a discretionary trust in her Will for the benefit of her grandsons Tom and Jerry. The trust fund contains cash and investments. Jane and Peter (Tom and Jerry's parents) are the trustees.

Norma wanted the trust to help her grandsons 'make a good start in life'. Jane and Peter are happy to make decisions about using the trust fund but prefer to get professional help with the tax and legal aspects of managing the trust. Tom has just turned 17, so the fund is used to pay for driving lessons and a car. The trust will also cover his university fees, which the trustees pay directly. Jerry, 23, graduated two years ago and is working full-time. The trustees decide to pay off his student debt and help him with a deposit on his first home.



## **Inheritance Tax**

Whether inheritance tax charges apply during the first ten years of the trust depends on the starting value of the trust and if this exceeds the Nil Rate Band (NRB) which is currently £325,000 until 2026.

### **Example 1: Starting value is £300,000**

- There are no exit charges on distributions from the trust during the first ten years.
- The trust fund will be revalued at the ten-year anniversary and if it is below the NRB at the time, no charges will apply. If it is above the NRB, a maximum rate of 6% on the value of assets above the NRB may apply.

### **Example 2: Starting value is £800,000**

- As the value exceeds the NRB, the trust may be liable to exit charges on distributions from the trust at a maximum of 6% on the value of assets above the NRB. The actual rate is calculated based on when the distribution from the trust is made.
- The trust fund will be revalued at the ten-year anniversary. Whether exit charges continue to apply depends on whether the trust fund is above or below the NRB at the time.

## **Income Tax**

During the trust period, Jane and Peter will need to submit annual tax returns, declaring all the income received by the trust. The income tax rates for the applicable tax year will apply.

Jane and Peter issue a tax certificate at the end of each tax year. Tom is a non-taxpayer, so he claims back all the income tax paid by the trust. Jerry is a basic rate taxpayer, so he reclaims the tax paid at the higher rate.

## **Capital Gains Tax**

If the trustees sell Norma's investments, there may be Capital Gains Tax to pay if the investments have increased in value since she died. The trust allowance is half the personal allowance. The trustees could choose to appoint investments to Tom or Jerry so they can use their own personal allowances and potentially reduce the tax liability.

## **Planning opportunity**

Suppose by the time Norma dies, Tom and Jerry are older and in steady jobs. The trustees may decide there is no need for the trust and want to appoint all the assets to Tom and Jerry equally.

If they do this within two years of Norma's death and comply with legal formalities, for tax purposes the gifts to Tom and Jerry are treated as if they were made in Norma's will. Exit fees would not apply and Tom and Jerry inherit the assets from the trust at the value they held when Norma died.

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