

THE TAXATION OF LIFETIME DISCRETIONARY TRUSTS...

When considering setting up a Discretionary Trust, you must consider the impact of three different taxes. This means not looking at each tax in isolation but considering how they interact.

The following notes are by no means exhaustive and are intended to provide only an outline of the taxes. You should always seek our advice on the specific details of your proposed Trust.

This focus on applies to lifetime discretionary trusts. Some of the points also apply to discretionary trusts created in a will. Most commonly, those created by will were nil rate band discretionary trusts which are still created but not for inheritance tax planning purposes and therefore we do not now draft very many of them in client's wills. This is because the inheritance tax planning advantage was to make sure that the nil rate band of the first spouse to die was not "wasted" by leaving it all to the surviving spouse. It is now possible for the executors of the surviving spouse to claim a transfer of the unused nil rate band of a predeceased spouse so that the "double" nil rate band can still be achieved even if, on the first death, the whole estate passes to surviving spouse.

The reason why not many new lifetime discretionary trusts are created is probably because the tax liabilities on the trustees are more onerous than they used to be and they are therefore less attractive to people of average means.

INHERITANCE TAX

1. Creation

A lifetime gift into a Discretionary Trust is a chargeable event and Inheritance Tax will be charged if the value of the gift plus the value of all other chargeable gifts in the previous 7 years exceed the nil rate band threshold, currently £325,000.

The settlor is entitled to any available Inheritance Tax annual exemption of £3,000 in the year the Trust is created, together with unused annual exemption from the previous year.

A lifetime gift into a Discretionary Trust within the nil rate band threshold will be free from all charge to Inheritance Tax, provided the settlor survives the gift by 7 years.

If the settlor dies within 7 years, the value of the gift will have to be aggregated with the settlor's estate for the purposes of calculating Inheritance Tax, together with any other transfers made in the previous 7 years. (It is the value of the gift at the date of the gift, not the date of death, which must be aggregated because a lifetime gift "freezes" the value of the gifted property. Any increase in the value of the property will be in the hands of the trustees of the Discretionary Trust.)

If the settlor does not survive the gift by 7 years, the gift may become chargeable at death rates to Inheritance Tax if the total of all lifetime gifts within the 7 years prior to death exceed the nil rate band. Inheritance Tax is only payable on the value of the gift which, when added to the 7 year cumulative total of lifetime gifts, exceeds the nil rate band. The amount of tax actually

These notes relate only to the Law in England and Wales. They are by no means exhaustive but we hope that they will help to avoid some of the difficulties which may arise. Please raise any queries with us as soon as possible.

payable (but not the value of the gift) reduces proportionally where death occurs more than 3 years after the date of the gift. For the gift to be effective, the settlor and his spouse, whether current or future, must **not** retain any benefit in the gift at all.

2. Duration

Every 10 years, under current legislation, there is a charge to Inheritance Tax. On the 10th anniversary the Trust Fund is valued. Any sum in excess of the nil rate band of tax then applying, together with the value of any appointments out of the Trust, is taxed at 30% of the death rates – currently 6%.

3. Termination

On the termination of a Discretionary Trust or any appointment out of it, a chargeable event occurs and tax will be charged in accordance with the value then applying.

If the Discretionary Trust is set up within the nil rate band of Inheritance Tax, any gifts out of it before the 10th anniversary will be exempt from Inheritance Tax under current legislation.

If any Inheritance Tax is payable, then that will be at current rates - a maximum 6%.

3. Termination

When a beneficiary becomes entitled to any portion of the Discretionary Trust assets, as against the trustees, there is a deemed disposal by the trustees for Capital Gains Tax purposes of this portion so transferred to the beneficiary. Again, the payment of tax may be deferred by way of a hold-over election into the hands of a UK-resident beneficiary so that any tax charge will only become crystallised when he disposes of the asset received.

INCOME TAX

1. Creation

Provided that the settlor, his spouse or any unmarried minor child of theirs does not benefit, nor retain any benefit in the Trust funds, there are no Income Tax implications, apart from the fact that there will be less income in the hands of the settlor and that may reduce his/her overall Income Tax liability.

2. Duration

The trustees' liability to Income Tax depends on the type of income-producing assets held and is currently at the rate of either 20% or 42.5%.

CAPITAL GAINS TAX

1. Creation

A gift into a Discretionary Trust is a disposal for Capital Gains Tax purposes and the usual rules apply to calculate any gain arising, which is payable by the settlor.

Capital Gains Tax is not, however, payable in respect of a gift of cash, cash not being a chargeable asset.

Any capital gains arising on a gift into a Discretionary Trust can generally be held over into the hands of the trustees, provided both the settlor and the Trust are UK-resident. The trustees are not required to join in the holdover claim. The effect is that any Capital Gains Tax charge will only become crystallised when the trustees dispose of the assets received.

2. Duration

The Trustees are liable to pay Capital Gains Tax on any realised gain arising on trust property each year which is 28%. The trustees have an annual Capital Gains Tax allowance which is one-half of that applicable to an individual. The amount is £5,050 for the tax year 2010/11.

Beneficiaries who are basic-rate tax payers may be able to reclaim some of the Income Tax suffered by the Trust.

3. Termination

On the termination of a Discretionary Trust, the Trustees cease to be liable for any further Income Tax, because the assets and the income produced by them now belong to the ultimate beneficiaries.

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