Discretionary Trust Factsheet

What is a Discretionary Trust?



A Discretionary Trust is one of the most flexible and adaptable forms of trust available under the law of England and Wales. It enables assets to be managed by trustees for the benefit of a group of beneficiaries, while leaving decisions about how, when and to whom funds are distributed entirely at the trustee's discretion.

This structure is particularly useful where the settlor (the person creating the trust) wishes to make provision for several people but does not want to give any individual a guaranteed share or fixed entitlement. It allows assets to be protected, family wealth to be preserved, and financial support to be provided as and when it is needed.

In a Discretionary Trust, the trustees hold and manage assets on behalf of a range of potential beneficiaries. However, unlike other types of trusts, such as an interest in possession trust, no beneficiary has an automatic right to income or capital. Instead, the trustees have complete discretion over:

- Whether any distributions are made.
- Which beneficiary or beneficiaries receive a distribution; and
- How much each beneficiary should receive.



The beneficiaries are normally described as a class, such as "my children, grandchildren and their spouses," giving the trustees a wide choice of who may benefit. This makes it an extremely versatile structure.

The settlor can set out their wishes in a Letter of Wishes, which provides guidance (but not legally binding instructions) to the trustees on how they might exercise their discretion. For example, the settlor may express a preference for funds to be used for education, housing, or medical needs.

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Key Benefits and Reasons to use a Discretionary Trust

A Discretionary Trust can serve a wide range of family and estate planning objectives. Some of the main advantages include:

Flexibility:

- Trustees can adapt their decisions to the changing circumstances of beneficiaries, such as changes in financial need, marital status, health, or tax position.
- There is no obligation to distribute income or capital equally or at all; distributions can be made as and when appropriate.
- The trust can last for many decades, providing flexibility over several generations.

Asset Protection:

- Because beneficiaries do not own the trust assets outright, those assets are generally protected from third-party claims.
- This can help safeguard family wealth against risks such as:
  - Divorce or separation proceedings involving a beneficiary.
  - Bankruptcy or creditor claims; or
  - Poor financial management by beneficiaries themselves.
- The trust acts as a protective "wrapper" around family wealth.

Control and Continuity:

- The settlor can exert a degree of ongoing influence through their choice of trustees and through the Letter of Wishes.
- The trustees continue to manage and administer the assets after the settlor's death, providing continuity and stability for the family.
- Distributions can be made gradually allowing funds to be preserved and sensibly managed.

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Protection for the Vulnerable or Younger Beneficiaries:

- Discretionary Trusts can be a valuable way to support beneficiaries who are too young or financially inexperienced to manage large sums.
- The trustees can release funds for their benefit as needed (for example, to pay school fees, living costs, or specific items) without giving the beneficiary direct control over capital.
- This structure also prevents funds from interfering with means-tested state benefits, as beneficiaries have no fixed entitlement to the assets.

Tax and Estate Planning Benefits:

- A Discretionary Trust can remove assets from the settlor's personal estate for inheritance tax purposes while still allowing the settlor to influence how those assets are used.
- It provides an opportunity to use the available nil rate bands and allowances effectively, particularly where family wealth exceeds the inheritance tax threshold.

Wealth Preservation:

- Trustees can invest the trust fund and distribute income or capital strategically, ensuring that wealth is preserved for the long-term benefit of the family rather than being dissipated through immediate inheritance.

How a Discretionary Trust Works in Practice:

Creating the Trust:

A Discretionary Trust can be created:

- During lifetime – through a formal Trust Deed (known as a lifetime or inter vivos trust); or
- On death – through provisions in a Will.

The settlor transfers assets such as cash, property, shares, or life insurance proceeds into the trust. Once transferred, the assets belong to the trust, not the settlor personally.

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Role of the Trustees:

The trustees are the legal owners of the trust assets and are responsible for:



- Managing the trust fund wisely.
- Making decisions about when and to whom payments should be made.
- Keeping accurate records and preparing annual accounts.
- Registering and maintaining the trust on the HMRC's Trust Registration Service (TRS); and
- Ensuring compliance with tax obligations and the terms of the trust.

Trustees must act unanimously, fairly, and in the best interests of all potential beneficiaries. Their discretion must be exercised properly, not arbitrarily or capriciously.

Beneficiaries' Position:

Beneficiaries under a Discretionary Trust have only a potential interest, that is, the possibility of receiving a benefit. They cannot demand payments or claim ownership of any part of the trust fund. This limited right is one of the key reasons a Discretionary Trust offers strong asset protection.





Duration of the Trust:

Under the current law, most trusts can last up to 125 years unless the deed provides for an earlier end date. This long duration allows wealth to be preserved over several generations.

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Inheritance Tax (IHT) Consequences:

Discretionary Trusts are subject to the "relevant property regime" for inheritance tax purposes. This means there may be IHT charges when the trust is set up, at 10-year intervals, and when capital is distributed.

When the Trust is set up During Lifetime:

- The transfer of assets into the trust is a Chargeable Lifetime Transfer (CLT).
- If the value of the transfer, together with any other CLTs made by the settlor in the previous seven years, exceeds the available nil rate band (£325,000 in 2025/26), a lifetime charge of 20% applies on the excess.
- If the settlor dies within seven years of creating the trust, further IHT may be payable to bring the total tax up to the death rate of 40%.
- The assets are then outside the settlor's estate for the future IHT purposes (assuming no reservation of benefit and subject to certain anti-avoidance rules)

When the Trust is Created on Death:

- If a Discretionary Trust is created by Will, the initial transfer of assets into the trust is part of the deceased's taxable estate.
- After the estate is administered, the trust becomes a "relevant property trust" and is subject to the same ongoing regime as a lifetime trust.

Ten-Year (Periodic) Charge:

- Every 10 years, the trust is assessed for IHT at up to 6% on the value of assets above the available nil rate band.
- The calculation takes into account any chargeable transfers made by the settlor in the seven years before the trust's creation.
- Although the percentage rate is not so high, the actual tax payable is often modest due to the way the charge is calculated.

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Exit (Proportionate) Charges:

- When capital is distributed out of the trust between 10-year anniversaries, a proportionate IHT charge may apply.
- The rate depends on how long after the last 10-year charge the distribution occurs.
- Professional advice is usually required to calculate this accurately.

Capital Gains Tax (CGT) Overview:



Discretionary Trusts can also give rise to capital gains tax (CGT) liabilities in certain situations.

Transfers into the Trust:

- When the settlor transfers assets into the trust during their lifetime, it is treated as if they had sold those assets at market value.
- This may trigger a capital gain, but in most cases hold-over relief (s.260 TCGA 1992) can be claimed to defer the gain until the trustees later dispose of the assets.

Trustees Tax Position:

- Trustees are subject to CGT on gains made when they sell or dispose of trust assets.
- Trustees have a smaller annual exemption (usually half the individual allowance).
- Gains above the exemption are taxed at 24%

Distributions to Beneficiaries:

- When assets are appointed out of the trust to beneficiaries, a CGT liability can arise based on the increase in value since the trust acquired by them.
- Hold-over relief may again be available to defer this gain.

Because of these complexities, the trustees should always take specialist tax advice before selling or distributing assets.

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Income Tax Overview:



Trustees of Discretionary Trusts are responsible for paying income tax on the trust's income.

Tax Rates:

- Most income is taxed at the trust rate of 45% (or 39.35% for dividend income).
- Trustees receive a standard rate band for £500 per year, which is taxed at basic rates (20% for non-dividend income and 8.75% for dividend income).
- Where a settlor has created more than one trust, this allowance is divided by the number of discretionary trusts they have.

Distributions to Beneficiaries:

- When trustees distribute income to a beneficiary, it is deemed to be paid net of 45% tax.
- The beneficiary receives a tax credit for this tax, which they can use to offset their own liability or reclaim some of the tax if they are a lower-rate taxpayer.
- This mechanism prevents double taxation but can make tax reporting more complex.

Trust Administration:

- Trustees must register the trust on HMRC's Trust Registration Service (TRS).
- An annual Trust and Estate Tax Return must be completed if the trust has income, gains, or a tax liability.
- Trustees are responsible for keeping detailed records of income, distributions, and expenses.

Summary:

A Discretionary Trust offers one of the most powerful and flexible structures in estate planning. It allows wealth to be managed for the benefit of a chosen group while giving trustees the freedom to adapt to changing circumstances. This ability to protect assets, support family members fairly, and manage tax exposure makes this trust especially valuable.

However, Discretionary Trusts are also subject to complex tax rules and administrative requirements.

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Example in Practice:



Example One:

Mrs Anderson has three adult children with varying financial needs. One is financially secure, another is going through a divorce, and the third has long term health issues. She creates a Discretionary Trust under her Will for her children and grandchildren.

Her trustees can use their discretion to:

- Support the child with health issues through regular payments for care.
- Delay distributions to the child in the middle of divorce proceedings; and
- Make larger distributions to the grandchildren in the future for education and housing.

This structure allows Mrs Anderson's assets to be used wisely and fairly over time, providing long-term protection and flexibility for her family.



Example Two:

Mr and Mrs Bennett wish to provide for their children and grandchildren but are unsure what their future needs might be. They set up a Discretionary Trust and transfer investments worth £300,000 into it. Their trustees can distribute income and capital to any of the family as circumstances dictate, such as paying for grandchildren's education, helping with housing, or supporting a child during illness.

Ten years later, the trust is valued at £450,000. A 10-year charge is calculated, but because the trust's value is within the nil rate band, no IHT is payable. The trust continues to operate, allowing the family to retain flexibility and control for future generations.

Disclaimer

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