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Tax treatment of Discretionary Trusts and 'Relevant Property Trusts'

This leaflet provides information about the tax treatment of discretionary trusts which can be created by Will or during the Settlor's lifetime.

The tax regime is also applicable to trusts classed as 'Relevant Property Trusts' by HM Revenue & Customs even though some of these may not be fully discretionary.

Capital Gains Tax

The trustees are a separate entity for Capital Gains Tax purposes and are liable to pay tax on any gains the trust makes over and above the annual allowance.

Gains are calculated by reference to the market or sale value of the asset at the date the trust disposed of it, compared to the value at the date the trust acquired it. Certain deductions are allowable to reduce the gain.

The annual allowance for trusts is half of that of an individual – currently (2022-2023) £12,300 (£6,150 for trusts).

If a beneficiary of the trust is occupying a property owned by the trustees then the trust can mitigate Capital Gains Tax by using the main residence relief provisions. However there is no rebasing of asset values on the death of a discretionary beneficiary.

Any investments owned by the trustees should be carefully managed to reduce this tax burden. Any transfer of an asset out of the trust may give rise to a liability if there has been a substantial gain prior to distribution though in some circumstances holdover relief may apply.

Capital Gains Tax rates vary depending on the nature of the asset disposed of. Residential Property is taxed at 28% while other chargeable assets are taxed at 20%. This is subject to change by the government.

Income Tax

The trustees are also responsible for paying tax on any income received by the trust. Trustees do not have the benefit of any personal allowance.

The first £1,000 is taxed at 8.75% (dividend income) or 20% (all other types of income). Thereafter dividend income is taxed at 39.35% while all other income is taxed at 45% (2022-2023).

If income is distributed during the year, the person who receives the income may claim back the extra tax paid by the trust, if they are a non tax or basic rate tax payer. Therefore, careful planning can mitigate the additional income tax burden and distributions of the trust income can use up the personal allowances of young beneficiaries who have no other income.

Inheritance Tax

If a trust is created whereby a beneficiary has a legal entitlement to income or capital from the trust or any part of it, then on that beneficiary's death he or she may be treated as owning the trust fund which is aggregated with their own estate for Inheritance Tax purposes. With a discretionary or relevant property trust, no-one can say that they are legally entitled to any part of the income or capital and therefore the fund cannot be treated as belonging to anyone and cannot be taxed on their death.

As a result, under Inheritance Tax rules, there are provisions for an exit charge on each distribution from the trust and a ten yearly charge once the trust has been in existence for that period. Upon every tenth anniversary the trust value in excess of the Nil Rate Band will be taxed at a maximum rate of 6% of its value. Distributions from the trust during the trust period will also be subject to a proportional charge if made in years between ten yearly anniversaries of the trust being created.

The rate of Inheritance Tax payable compares favourably with the 40% applicable on death. In addition, if the value of the trust does not exceed the Nil rate band at the time the trust is implemented or at the time of any assessment then there will be no tax to pay. There is also no Inheritance Tax to pay on the creation of the trust, nor on its termination when the sum settled is less than £325,000.

If you require further information, please contact Mary Harty on 0117 9292811 or by email at: mary.harty@wards.uk.com Dec 2023