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Discretionary Trust

Overview
A discretionary trust gives trustees discretion over which beneficiaries benefit, when they benefit and how much they receive. No beneficiary has an automatic entitlement to benefit.

How It Works
The trustees exercise discretion in accordance with the trust deed and any letter of wishes, with beneficiaries typically forming a class rather than having fixed entitlements.

IHT Treatment
Lifetime transfers are usually Chargeable Lifetime Transfers (CLTs). Potential charges include 20% immediate IHT entry charge above the available nil-rate band (currently £325,000), ten-year periodic charges and exit charges.

Charge Type	Typical Maximum Rate
Entry Charge	20% lifetime rate
Ten-Year Charge	Up to 6%
Exit Charge	Proportionate rate

Most discretionary trusts fall within the relevant property regime.

Typical Uses:
- Family wealth protection
- Multi-generational planning
- Asset protection
- Bloodline planning
- Vulnerable family situations
- Future-proofing uncertain family circumstances

Suitable For:
- High-net-worth families
- Clients wanting flexibility
- Asset protection planning
- Business owners
- Clients concerned about divorce or bankruptcy risks

Usually Unsuitable For:

- Clients needing certainty of income rights
- Small estates where compliance costs outweigh benefits
- Clients unwilling to relinquish control

Advantages:

- High flexibility
- Strong asset protection potential
- Assets generally outside beneficiaries' estates
- Useful for future uncertainty
- Effective long-term succession planning

Disadvantages:

- Complex taxation
- Higher compliance burden
- Trust tax rates can be punitive
- Potential periodic and exit charges
- Trustee administration obligations
- Key Professional Advice Issues
- Relevant property regime calculations
- Nil-rate band usage
- CGT hold-over relief
- Reservation of benefit rules
- Pre-owned asset tax rules
- Trust Registration Service obligations
- Trustee fiduciary duties
- Letter of wishes drafting

Case Study – Investment Property Transferred into a Discretionary Trust

Scenario

Mr Smith has not made any other settlements but owns a buy-to-let property which he would ultimately like to pass to his children and grandchildren. However, he is concerned about future divorce claims, bankruptcy risks and the possibility that beneficiaries may not be financially mature enough to manage significant assets outright.

Rather than gifting the property directly to family members, a discretionary trust is established to provide long-term asset protection and flexibility. The property has the following value:

Item	Amount
Current Market Value	£500,000
Original Cost	£300,000
Capital Gain	£200,000
Outstanding Mortgage	Nil

The trustees are appointed from trusted family members and professional advisers, with a wide class of beneficiaries including children and future grandchildren.

Inheritance Tax Position
The transfer into the discretionary trust is a Chargeable Lifetime Transfer (CLT).

Where the objective is for the trust to receive the full property value of £500,000, there are two ways in which the Lifetime Inheritance Tax (the Chargeable Lifetime Transfer (CLT)) can be funded.

Option 1 – The Trust Pays the Tax
A further £43,750 would need to be settled into the trust to enable the trustees to pay the Lifetime Inheritance Tax.

Total amount settled into the trust	£543,750
Less: Available Nil Rate Band	£325,000
Chargeable amount	£218,750
Lifetime IHT at 20%	£43,750

The trust therefore receives assets with a net value of £500,000, with the additional £43,750 being used to meet the tax liability.

Option 2 – The Settlor Pays the Tax Personally
Alternatively, the property can be settled into the trust at £500,000, with the Lifetime Inheritance Tax paid personally by the settlor.

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Amount settled into the trust	£500,000
Less: Available Nil Rate Band	£325,000
Chargeable amount	£175,000

Where the settlor pays the tax personally, the payment of that tax is itself treated as a further transfer of value for Inheritance Tax purposes. Consequently, the transfer must be grossed up.

The grossing-up calculation is:

£175,000 × 25% = £43,750

Accordingly, the total Chargeable Lifetime Transfer is:

£500,000 + £43,750 = £543,750

Summary

Regardless of whether the tax is paid by the trust or by the settlor, the effective Chargeable Lifetime Transfer is £543,750. The difference lies only in how the tax is funded:

- **Trust pays the tax:** An additional £43,750 is settled into the trust to fund the liability.

- **Settlor pays the tax:** The tax is paid personally, and the transfer is grossed up under the Inheritance Tax rules, resulting in the same effective transfer of £543,750.

These calculations assume that:

- no Chargeable Lifetime Transfers have been made by the settlor during the previous seven years; and

- the annual Inheritance Tax exemption has already been fully utilised.

Capital Gains Tax and Holdover Relief
A transfer of property into a discretionary trust is treated as a disposal at market value for Capital Gains Tax (CGT) purposes, even though no sale has taken place.

In this example, the property has a market value of £500,000 and a base cost of £300,000, giving rise to a capital gain of £200,000. Without relief, this would result in a potential CGT liability of £48,000 (assuming a 24% CGT rate).

However, because the transfer constitutes a Chargeable Lifetime Transfer (CLT) for Inheritance Tax purposes, Holdover Relief may be available.

Where Holdover Relief is successfully claimed, no Capital Gains Tax is payable at the time of the transfer. Instead, the gain is deferred, with the trustees acquiring the property at the settlor's original base cost of £300,000. The deferred gain will normally crystallise only when the trustees subsequently dispose of the property, unless Holdover Relief is available again on that later transfer.

For many property-owning clients, the ability to defer the Capital Gains Tax liability is one of the principal advantages of transferring assets into a discretionary trust.

To qualify for Holdover Relief, neither the settlor, the settlor's spouse or civil partner, nor the settlor's unmarried minor children (including children under the age of 18 who are not in a civil partnership) can be capable of benefiting under the trust.

This restriction applies only on the initial transfer into trust. It does not prevent Holdover Relief from being claimed when assets are later appointed out of the trust. However, special restrictions can apply where residential property has qualified for Principal Private Residence Relief while held in the trust, and these would need to be considered separately.

SDLT Considerations
Where an unencumbered property (one with no mortgage) is transferred into a discretionary trust for no consideration, there will generally be no Stamp Duty Land Tax (SDLT) liability.

However, a different outcome can arise where the property is subject to an existing mortgage.

To the extent that the trust takes the property subject to the outstanding debt, the amount of that debt is treated as chargeable consideration for SDLT purposes.

For example:

Item	Amount
Property Value	£500,000
Outstanding Mortgage	£200,000

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In this example, the £200,000 outstanding mortgage is treated as consideration for SDLT purposes. Assuming the higher residential rates apply, this would result in an SDLT liability of £11,500, calculated as:

- £125,000 at 5% = £6,250
- £75,000 at 7% = £5,250

Total SDLT: £11,500

This charge arises even though no money changes hands, as the legislation treats the assumption of the secured debt as consideration.

The SDLT position can vary depending on the nature of the property, the amount of debt secured against it, the identity of the beneficiaries and trustees, and whether any reliefs are available. Specialist advice should therefore always be obtained before transferring a mortgaged property into trust.

Ongoing Taxation of the Trust

Income Tax
Income arising within a discretionary trust is generally taxable on the trustees. Where annual trust income exceeds £500 then tax is due on the whole amount not just on the excess over £500 and is subject to the special trust rates.

For the 2026/27 tax year:

Type of Income	**Tax Rate**
Rental Income	45%
Interest Income	45%
Dividend Income	39.35%

If we assume the property generates:

Item	**Amount**
Gross Rental Income	£15,000
Allowable Expenses	(£2,000)
Taxable Rental Income	£13,000

For the 2026/27 tax year the income tax payable is £5,850 being £13,000 at 45%.

When trustees distribute income to beneficiaries, the beneficiaries are generally treated as receiving it with a 45% tax credit, and they may be able to reclaim some of that tax if their own marginal tax rate is lower or where their personal allowance is available.

Capital Gains Tax
The trustees are generally liable to Capital Gains Tax on gains realised by trust assets.

Item	Amount
Annual Exempt Amount	£1,500
CGT Rate on Property Gains	24%
CGT Rate on Other Gains	24%

If we assume the property is sold for £900,000, then the following calculation for CGT would apply:

Item	Amount
Sale Proceeds	£900,000
Base Cost (held over)	£300,000
Gain	£600,000
Less Annual Exempt Amount	(£1,500)
Taxable Gain	£598,500

The potential CGT liability is therefore £143,640 (being, £598,500 × 24%).

If on the other hand the property was distributed from the trust to a beneficiary before 10 years from the settlements start date, then the trust could holdover the gain in which case the beneficiary would have a base cost of £300,000 available for a future disposal.

It should however be noted that the following exit charge would apply in these circumstances

Lifetime rate = 20% on £218,750 = £43,750

Effective rate: £43,750 ÷ £543,750 = 8.04598%
Notional exit rate: 8.04598% × 30% = 2.41379%

Exit charge: £900,000 × 2.41379% = £21,724

Ten-Year Periodic Charges
Most discretionary trusts fall within the Relevant Property Regime, meaning that every ten years, the trustees must review the value of the trust fund and determine whether an inheritance tax charge arises.

The maximum effective rate is generally 6% of the value exceeding the available Nil Rate Band.

Assume that ten years after the trust was established the property is worth £900,000:

Item	**Amount**
Trust Value	£900,000
Nil Rate Band	£325,000
Excess	£575,000

The potential maximum periodic charge is therefore £34,500 (being £575,000 × 6%).

The actual charge may be lower depending upon the trust's history and detailed inheritance tax calculations.

Exit Charges
When capital leaves the trust, an exit charge may arise.

The amount depends upon:

- The value distributed.
- The time elapsed since the previous ten-year anniversary.
- The effective rate established at the previous periodic charge.

Exit charges are often relatively modest but should always be reviewed before significant capital distributions are made.

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Long-Term Outcome
If we assume the property increases in value from £500,000 to £900,000 over a fifteen-year period:

Item	**Amount**
Initial Value	£500,000
Future Value	£900,000
Growth Outside Estate	£400,000

The further inheritance tax savings are therefore £160,000 (being £400,000 × 40%) that would otherwise have accrued in the settlors' estate.

In addition, the trustees retain control over the asset and can distribute income or capital amongst beneficiaries in accordance with changing family circumstances. The trust structure provides flexibility, asset protection and long-term succession planning whilst allowing the original capital gain to be deferred through Holdover Relief if the conditions are met.

A discretionary trust can therefore be an effective solution for clients wishing to transfer investment property to future generations whilst retaining flexibility and protecting family wealth.

Although the structure involves ongoing compliance obligations and may be subject to periodic and exit charges, the ability to defer Capital Gains Tax through Holdover Relief if the conditions are met, combined with long-term inheritance tax planning and asset protection benefits, often makes it a powerful estate planning tool.