

# ADVANCE PORTFOLIO DISCRETIONARY TRUST

## ADVISER NOTES

These notes give professional advisers general information about the Advance Portfolio Discretionary Trust. They assume a professional understanding of trusts and taxation and you should not rely on these notes alone when giving advice to your clients.

### The growing scope of inheritance tax (IHT)

For many married couples (including civil partners) the introduction of the transferable nil rate band and the residence nil rate band has reduced the potential IHT bill on their estates. Even so many married couples may find their combined estate is still above the level at which IHT becomes payable.

Those not married have one nil rate band which has been frozen until tax year end 2025/26. The residence nil rate band may also be available for certain transfers on death.

One effective way to reduce IHT is to make lifetime gifts. Only outright gifts to individuals and gifts to bare trusts (or trusts for the disabled) are potentially exempt transfers.

Many people may be reluctant to commit large sums for outright gifts or where the intended beneficiaries are minors or where there is a possibility of future beneficiaries.

Where control and flexibility over the eventual distribution of funds is important a discretionary trust can provide this. Where the individual is certain about their choice of beneficiary and does not need future flexibility, a bare trust may be appropriate for gifts to minor beneficiaries.

To be effective for IHT the person setting up the trust must not receive any benefit (actual or prospective) from the trust fund. Therefore, trusts are only suitable for those who do not want to retain any personal benefit from their investment.

### The Advance Portfolio Discretionary Trust

The Advance Portfolio Discretionary Trust enables someone to make a gift to others. The investments and income of the trust (the trust fund) are held for the benefit of the beneficiaries. The person setting up the trust cannot benefit from the trust fund in any way.

The trustees decide how the trust fund is invested and will make all investment decisions jointly, unless they have delegated those decisions to someone else.

Normally the person setting up the trust decides who receives the trust fund and when they receive it. After that person's death, the trustees jointly decide who benefits and when.

If any benefit is to be paid to the spouse (or civil partner) of the person who sets up the trust, this must be agreed by all the trustees which must include at least one person who is not the settlor or settlor's spouse.

Once the trust has been set up your client cannot change their mind. Therefore, you need to take account of the following:

- How the trust works and how it fits with your client's financial plans.
- The inheritance tax implications of the trust and who will calculate any tax due.
- How the trust fund will be taxed, both from an income tax and capital gains tax standpoint.
- The annual tax returns that may be needed and who will do this.
- The records the trustees will need to keep, especially when paying out money to the beneficiaries of the trust.

You must ensure the trust is properly set up. It's important that the trust deed is correctly completed, witnessed and signed by the right people. If this is not done properly the trust itself may fail or there could be problems at a later date.

The client must inform HMRC of the trust's creation by registering it with HMRC using the online Trusts Registration Service (TRS). If the gift exceeds a certain limit additional reporting is necessary.

## The trustees

The person setting up the trust (the settlor) will automatically be one of the trustees. If it's a joint investment, both people will be joint settlors and both will be trustees.

The settlor can appoint other trustees either from the outset or later. After the settlor's death the trustees can appoint further trustees.

The settlor can remove a trustee provided at least two trustees remain, one of whom is not the settlor, their spouse or civil partner.

It is usually suggested that additional trustees should be appointed at outset, particularly because after your client's death the trust will continue. The trustees will in time decide who receives the trust fund and so an understanding of your client's objectives could be a help to them.

Having additional trustees means that should the settlor die there will be no interruption to the trust caused by probate delays. If there are no additional trustees, no new trustee can be appointed until after probate has been obtained.

The trustees have control of the trust fund and must jointly make many of the key decisions including how the trust fund is invested.

You should explain the role of the trustee to each trustee and help your client decide how many trustees to have and who might be suitable given their circumstances.

You must give each trustee a full copy of the completed trust deed, any deeds appointing new or retiring trustees, and any deeds appointing new beneficiaries or appointing benefits to a beneficiary. You may send them an electronic copy if you wish.

## The beneficiaries

The beneficiaries have no fixed right to the trust fund. Instead they will receive the trust fund, or a part of it, when the settlor decides. After the settlor's death the trustees decide who benefits. Some beneficiaries may receive nothing.

Whenever benefits are paid to a beneficiary the trustees should keep a full record of the amounts paid. Appointments in favour of one or more of the beneficiaries should be made by deed.

The spouse (or civil partner) of a single settlor can be included as a possible beneficiary. This can only be done from outset by completing the trust deed correctly.

Including the settlor's spouse (or civil partner) as a possible beneficiary will result in all income of the trust fund being taxed as though it was the settlor's income (even though the actual income still belongs to the trust). Any payment to the settlor's spouse (or civil partner) must be agreed by all the trustees, even during the settlor's lifetime.

If a payment is made to the settlor's spouse (or civil partner) during the settlor's lifetime, care needs to be taken because, if the settlor is deemed to receive a benefit, or an indirect benefit, from the payment to their spouse (or civil partner), the gift with reservation rules will apply. This will bring the value of the trust fund into the settlor's estate for IHT purposes.

Default beneficiaries must be named in the trust deed. These are the people who will benefit should the trustees fail to make a decision. Whilst this is unlikely, it is necessary to properly set up the trust. As the trust could last up to 125 years the estate of the default beneficiaries will take their place if the default beneficiaries die before the trust ends.

The settlor can add other beneficiaries at a later date.

## Inheritance tax

There may be IHT to pay when the trust is set up. Where there are two settlors, each is normally treated as making a gift of one-half of the value of the amount transferred.

To the extent the gift exceeds the settlor's annual exemption, it will be a chargeable lifetime transfer. If this amount, plus the value of any other chargeable lifetime transfers made in the previous seven years, exceeds the nil rate band the excess will be immediately charged to IHT at the rate of 20%.

You or your client must tell HMRC about all chargeable lifetime transfers exceeding the nil rate band (when added to chargeable lifetime transfers made by the client in the previous seven years) and so IHT is due. Currently HMRC Form IHT100 should be used. The rules are more complex where an existing portfolio is to be placed into trust.

If the settlor dies within seven years of setting up the trust further IHT may be due on the value of the initial gift to the trust. It will also be included in the calculation of any IHT on their estate.

Every ten years there may be IHT to pay. This is called the periodic charge. The amount depends on the value of the trust fund (and any other set up on the same day) at the time of the periodic charge. Any capital paid out of the trust fund in the previous ten years is added to this along with the total chargeable lifetime transfers made in the seven years prior to setting up the trust. If this total exceeds the current nil rate band, the excess is taxed at a maximum of 6%. Any income which has been accumulated as an addition to the trust's capital or has remained undistributed for more than five years should be included in the valuation of the trust fund when calculating the periodic charge.

When the capital of the trust fund is paid to a beneficiary there may be some IHT to pay. This is called the exit charge. During the first ten years if the value of the trust fund at outset, plus the previous seven years chargeable lifetime transfers, is less than the current nil rate band there will be no exit charge. For payments out of the trust after ten years if there was no tax to pay at the last periodic charge, there will be no tax to pay on exit.

Otherwise an average rate of tax is calculated for the whole trust fund and is then applied to the capital being paid out. The result is then adjusted for the time (in quarters) since the trust was set up or, if later, since the last periodic charge.

The periodic and exit charge calculations are modified if further investments are added to the trust at any time.

If the value of the trust fund (plus the total of chargeable lifetime transfers made in the seven years prior to setting up the trust) is less than the nil rate band, there should be no IHT to pay.

The trustees are responsible for ensuring the necessary IHT calculations are done and reported to HMRC. Normally any IHT is paid by the trustees out of the trust fund. You should explain how IHT will affect the trust and what the trustees need to do to make sure all the right calculations and returns to HMRC are made.

## Income tax

The trustees need to pay tax on the income of the trust fund and report it to HMRC.

The first £1,000 of gross income is taxed on the trustees at the standard rates of tax, currently 7.5% (dividends) or 20% (interest). The standard rate is scaled back if the settlor has other trusts. The trustees do not qualify for a personal savings allowance or dividend allowance.

Trust income above the standard rate band is currently taxed at 38.1% on dividends and 45% on interest.

When the trustees distribute income to a beneficiary, they must first have paid 45% income tax on that income. This may mean they have additional tax to pay where, for example, the original income fell within their standard rate band or was dividend income taxed at 38.1%.

If the net income (after tax is paid by the trustees) is paid to a beneficiary who pays tax at a lower rate than the trust, the beneficiary may be able to reclaim from HMRC the extra tax paid. However, as the beneficiary will then be receiving trust income and not dividend income or an interest distribution, they will not be able to use their dividend allowance or personal savings allowance.

Special rules apply if the beneficiary is the settlor's minor unmarried child. If the child receives or benefits from gross income of more than £100 in a tax year (from all gifts from the settlor) that income will be assessed as the settlor's income.

The tax treatment is different if the settlor's spouse is included as one of the beneficiaries of the trust, whether they receive any income or not. Generally, all trust income will be treated as income of the settlor. The trustees will pay tax as normal but if the settlor pays tax at a lower rate the difference can be reclaimed from HMRC provided it is then paid back into the trust fund.

If trust income that has already been taxed on the settlor under the above provisions is actually paid to a beneficiary (after deducting trust tax), it will still carry a tax credit but none of this can be reclaimed by that beneficiary.

You should explain to the trustees how income tax will affect the trust and what they need to do to make sure all the right payments and returns to HMRC are made.

## Capital gains tax (CGT)

When assets in the Advance Portfolio are transferred into trust this will be a disposal for CGT purposes by the settlor. The gain will be calculated using the market value as the disposal price. Provided the settlor's spouse (or civil partner) or minor children are not beneficiaries, it should be possible to claim hold-over relief so that the taxation of the gain is deferred until the trustees later dispose of the investment.

The trustees pay CGT at a special trust rate of currently 20% on any subsequent trust investment gains above the trust's annual exemption. This is equal to half the individual annual exemption unless the settlor has set up more than one trust (ignoring any bare trusts) in which case the trust's annual exemption is shared across all those trusts subject to a minimum amount of one fifth of the annual exempt amount applicable to trusts.

You should explain to the trustees how capital gains tax will affect the trust and what they need to do to make sure all the right payments and returns to HMRC are made.

## HMRC Trust Register

We will require proof of registration with the HMRC Trust Register before we can complete set up of your account. A pdf downloaded from the Register is sufficient.

## Frequently asked questions

### Should both spouses (or civil partners) set up their own individual discretionary trusts?

This is only advisable where neither can benefit under the trust created by the other. If the settlor's spouse (or civil partner) is a potential beneficiary under each of the two trusts, these could be regarded as reciprocal arrangements and so invoke the gift with reservation provisions and not be inheritance tax efficient.

### Is the discretionary trust available for joint settlors?

Yes, but only where the couple are married or registered civil partners. In those circumstances the account must be set up in joint names and the trust deed executed by both. Each will normally be treated as settling 50% of the assets.

### What is the role of the nominee company and why is the Notice of Trust necessary?

As the underlying investments are held in the name of a nominee, in order to perfect the gift to the trust the settlor also instructs the nominee company to re-register the beneficial title in the name of the trustees.

### Why should payments not be made to the spouse (or civil partner) of the settlor whilst the settlor is alive?

The inclusion of the settlor's spouse (or civil partner) as one of the beneficiaries does not constitute a reservation of benefit for IHT purposes, but care must be taken if any benefits are actually paid to the settlor's spouse (or civil partner) during the lifetime of the settlor. It is absolutely essential that no part of these benefits finds its way back to the settlor in any way, directly or indirectly. If this were to happen, the trust could be seen as one under which the settlor reserved a benefit and this would make it ineffective for IHT purposes. In practice therefore, it may be advisable to avoid making such appointments altogether whilst the settlor is alive.

### Can an investor get their money back after making the investment?

The investor will get the usual cancellation rights for new investments. If they exercise those cancellation rights they will get a refund (subject to any shortfall) and the trust will have no assets and therefore no practical effect.

### How do the trustees find cash to pay income tax if they invest in accumulation shares/units?

If all the funds are invested in accumulation units/shares the trustees may have to sell some of the shares/units to raise the necessary cash.

### Can an existing portfolio be put into trust at the same time as making a further investment using one trust deed?

No. In this event the existing portfolio should be put into trust first. The settlor can then gift cash to the trustees who can then apply for the further investment.

### Are there any particular points to completing the trust deed?

There are guidance notes on the deed to help you but as the deed is an important legal document you must take care to complete it correctly. For new applications the trust deed must be signed and dated on or after the date the Portfolio declaration is signed and dated.

In Scotland the process of delivery or intimation is required to ensure the trust is effective. This means an additional trustee must be appointed at outset and they must receive a full copy of the trust deed.

### Do you need to see the original trust deed?

No. Your client will want to keep the trust deed safe and so it's best to avoid its potential loss through the postal system. You can scan a full copy of the trust deed into your computer and email us a copy. You may also find this a more convenient way to send a copy to the additional trustees.

### Important note for existing portfolios

Where an existing portfolio is placed into trust, when we record the trust we will allocate a new portfolio number so that we can administer the assets as part of a trust fund.

We will confirm this new reference number to you after we have received a copy of the trust deed. You should complete the trust deed with the original portfolio number as this correctly identifies the assets being placed into trust.

## Inheritance tax calculations

These examples show the general nature of the IHT calculations. They are a guide only and do not take account of all scenarios for which specialist tax advice is necessary. If the value of the trust remains below the nil rate band, there could be no IHT to pay.

### Creating a discretionary trust

Initial value of the gift into trust (in excess of annual exemption)	= a
Plus value of chargeable lifetime transfers in previous 7 years	= b
Minus current nil rate band	= c
Immediate charge to IHT @ 20%	= (a+b-c) x 0.2

### Exit charge during first ten years

Initial value of the gift into trust (in excess of annual exemption)	= a
Plus value of chargeable lifetime transfers in previous 7 years	= b
Minus current nil rate band	= c
Effective rate of tax <sup>1</sup>	= $\frac{(a+b-c) \times 0.2}{a}$
Value of capital distribution	= d
Number of complete quarters since creation of trust	= nq
Exit charge @ 30% of the effective rate	= d x 0.3 x effective rate x (nq/40)

### Periodic charge every 10 years

Current value of trust fund	= a
Plus value of chargeable lifetime transfers in 7 years prior to trust <sup>2</sup>	= b
Plus value of capital distributions in last 10 years	= d
Minus current nil rate band	= c
Effective rate of tax	= $\frac{(a+b+d-c) \times 0.2}{a}$
Ten year charge @ 30% of the effective rate	= a x 0.3 x effective rate

### Notes

- 1 The effective rate calculated at each ten year anniversary is used in the calculation of exit charges during the following ten years
- 2 If additions have been made to the trust, the value of chargeable lifetime transfers in the 7 years prior to the addition is used instead if that value is greater

## Example 1

Assume a gift into trust of £100,000. All annual exemptions have been used. No other chargeable lifetime transfers have been made. After six years the trustees pay a beneficiary £10,000. At the first ten year anniversary the trust fund is worth £160,000. The nil rate band increases during this time.

### Creating the discretionary trust

Initial value of the gift into trust (in excess of annual exemption)	= £100,000
Plus value of chargeable lifetime transfers in previous 7 years	= £0
Minus current nil rate band	= £325,000
Immediate charge to IHT @20% of excess over nil rate band	= nil

### Exit charge after six years

Initial value of the gift into trust (in excess of annual exemption)	= £100,000
Plus value of chargeable lifetime transfers in previous 7 years	= £0
Minus current nil rate band	= £350,000
Effective rate of tax on excess over nil rate band	$= \frac{£0 \times 0.2}{£100,000}$
Value of capital distribution	= £10,000
Number of complete quarters since creation of trust	= 24
Exit charge @ 30% of the effective rate	$= £10,000 \times 0.3 \times 0 \times (24/40) = \text{nil}$

### Periodic charge at first 10 year anniversary

Current value of trust fund	= £160,000
Plus value of chargeable lifetime transfers in 7 years prior to trust	= £0
Plus value of capital distributions in last 10 years	= £10,000
Minus current nil rate band	= £375,000
Effective rate of tax on excess over nil rate band	$= \frac{£0 \times 0.2}{£160,000}$
Ten year charge @ 30% of the effective rate	$= £160,000 \times 0.3 \times 0 = \text{nil}$

## Example 2

Assume a gift into trust of £400,000. All annual exemptions have been used. No other chargeable lifetime transfers have been made. After six years the trustees pay a beneficiary £10,000. At the first ten year anniversary the trust fund is worth £660,000. The nil rate band increases during this time.

### Creating the discretionary trust

Initial value of the gift into trust (in excess of annual exemption)	= £400,000
Plus value of chargeable lifetime transfers in previous 7 years	= £0
Minus current nil rate band	= £325,000
Immediate charge to IHT @ 20% of excess over nil rate band	= £15,000

### Exit charge after six years

Initial value of the gift into trust (in excess of annual exemption)	= £400,000
Plus value of chargeable lifetime transfers in previous 7 years	= £0
Minus current nil rate band	= £350,000
Effective rate of tax on excess over nil rate band	$= \frac{£50,000 \times 0.2}{£400,000}$
Value of capital distribution	= £10,000
Number of complete quarters since creation of trust	= 24
Exit charge @ 30% of the effective rate	$= £10,000 \times 0.3 \times 0.025 \times (24/40) = £45$

### Periodic charge at first 10 year anniversary

Current value of trust fund	= £660,000
Plus value of chargeable lifetime transfers in 7 years prior to trust	= £0
Plus value of capital distributions in last 10 years	= £10,000
Minus current nil rate band	= £375,000
Effective rate of tax on excess over nil rate band	$= \frac{£295,000 \times 0.2}{£660,000}$
Ten year charge @ 30% of the effective rate	$= £660,000 \times 0.3 \times 0.0894 = £17,700$

These notes are for professional advisers only. They are based on our understanding of law and practice in December 2021, which can change over time. No investment or tax decision should be made on the basis of these notes alone. It is assumed that advisers have a professional understanding of trusts and taxation. These notes are not intended to be comprehensive nor a substitute for ongoing professional study. Where appropriate specialist legal and tax advice should be obtained.