

Discretionary and accumulation and maintenance trusts - a quick guide

Synopsis: Key characteristics explained

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Discretionary trusts

A discretionary trust gives the trustees complete discretion as to whether to pay trust income out to any one or more of the beneficiaries or to accumulate it within the trust (contrast an interest in possession trust where the trustees must pay income to a beneficiary if it arises).

A discretionary trust will also usually give the trustees discretion as to which person(s), from a prescribed list (or class) of beneficiaries, should benefit from the trust income and capital.

Typically, several classes of beneficiary, including spouse, civil partner, children, grandchildren, siblings, parents, charities, etc., are included in the discretionary class. No beneficiary has a right to any benefit until the trustees (or whoever is the appointor under the trust) makes an appointment in their favour.

Pre-22 March 2006 discretionary trusts

A special inheritance tax (IHT) charging regime applies to discretionary trusts and prior to the changes to the tax treatment of trusts in FA 2006 it was not very common to come across discretionary trusts of life policies. The exception to this was pension trusts, which were always commonly discretionary because they are exempt from the special IHT charging regime.

Despite the fact that they have not historically been used with life assurance policies, discretionary trusts have always been commonly used in estate planning and are often used to take advantage of the nil rate band for IHT (although following the introduction of the transferable nil rate band, this is less relevant).

Discretionary trusts were also thought to be attractive in cases where there was likely to be lots of future appointments, i.e. many potential changes of beneficiary. In such cases, interest in possession trusts may not have been appropriate in view of the IHT implication of changes of beneficiaries (i.e. a potentially exempt transfer (PET) arising on each change).

Post-21 March 2006 Budget discretionary trusts

The IHT treatment of the discretionary trust was not significantly changed by the 2006 Finance Act. However, the IHT discretionary trust charging regime was widened to apply to almost all lifetime trusts (other than bare trusts and trusts for the disabled) executed on or after 22 March 2006. The likelihood of charges to tax arising in connection with single premium investment policies held on trust is, of

course, far greater than when regular premium protection-based policies are held subject to non-bare trusts.

The 2006 changes led to the majority of providers withdrawing their flexible interest in possession trusts and re-launching their trust proposition to offer a choice between a discretionary trust and a bare trust. This is largely because, for life policies, that produce no income, the flexible interest in possession trust now has no advantage over the discretionary trust and the discretionary trust, with just one class of potential beneficiaries, is simpler to understand.

Accumulation and maintenance trusts

The accumulation and maintenance (A&M) trust was a tax-favoured type of discretionary trust which was typically used to enable the settlor's children or grandchildren to benefit from either trust capital, or, at the very least, trust income between age 18 and age 25 at the latest.

Provided the trust fulfilled certain conditions then it received favourable treatment for IHT purposes. For example, there would be no periodic or exit charges to IHT which apply to ordinary discretionary trusts.

Historically some life offices offered A&M trusts to take advantage of the PET regime when it was first introduced in 1986. However, since the tax treatment of such trusts was fairly complex, when PET treatment was extended to interest in possession trusts in 1987 (please see Flexible trusts with power of appointment) it became less common to use A&M trusts with life policies.

A&M trusts could also arise inadvertently prior to 22 March 2006, where the trust was supplied in a draft form that allowed the settlor to insert his or her own trust wording. This might happen, for example, where a trust was declared for the benefit of a minor child without giving the beneficiary a vested right to income (so that the statutory provisions of section 31 Trustees Act 1925 came into play with the result that the trust would satisfy the criteria for an A&M trust until the child's 18th birthday) or where children were given a contingent interest (for example "for such of my children as survive me") with no additional clause confirming that in the meantime the children would have an interest in possession.

Since 22 March 2006, it has not been possible to create new A&M trusts, and existing A&M trusts will have become subject to the discretionary trust regime from 6 April 2008 unless the trust either already provided for beneficiaries to become absolutely entitled to the trust property by age 18 – or the trust was amended before 6 April 2008 to ensure that this would happen.

A relaxed application of the discretionary trust regime takes place if the trust provides that the beneficiaries will become absolutely entitled to the trust benefits by age 25 – i.e. '18-25' rules.

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