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wills & probate

Discretionary Vs Absolute Trusts Key Information

This document looks at the use of trusts and outlines the main differences between discretionary and absolute trusts and which one should be used in which situation.

A trust is simply a way of transferring an asset but keeping control. Trusts are often used in financial planning; the main reasons are:

- Inheritance Tax (IHT) or tax mitigation.
- Avoidance of probate delays.
- Asset protection.

When creating a trust the **settlor** (person who sets up the trust) splits the ownership of the asset in trust. The legal ownership goes to the **trustees** (the legal owners of an asset) and the beneficial ownership goes to the **beneficiaries** (the individuals entitled to the asset).

Two types of trust are commonly used, discretionary and absolute.

Discretionary trusts

- Variable Discretionary Trust – used with investment bonds or protection plans.
- Asset Preservation Trust – used to place death benefits from pension schemes into trust after death.

Absolute trusts

- Absolute Trust – used with investment bonds, protection plans and in some circumstances unit trusts.

The table below is a summary of the similarities and differences between the trusts:

Characteristic	Absolute	Discretionary
Can a beneficiary be changed?	No	Yes
Can a beneficiary demand assets?	Yes	No
Is the gift a Chargeable Lifetime Transfer (CLT) or a Potentially Exempt Transfer (PET)	PET	CLT
Is there the possibility that the gift may need to be reported to HM Revenue & Customs?	No	Yes
Is the trust subject to IHT at ten year anniversaries or on exit?	No	Yes, unless careful planning has been undertaken
Are the assets in the trust protected from divorce or bankruptcy proceedings?	No	In some cases yes

Frequently asked questions

Can a beneficiary be changed?

The beneficiaries cannot be changed, nor their share, in the absolute trust. This is because the beneficiaries are ABSOLUTELY entitled to their shares. This can be contrasted with the discretionary trust. In a discretionary trust, the trustees have a DISCRETION to change, add or remove the beneficiaries. This is the fundamental difference between the two trusts.

Can a beneficiary demand assets?

Under an absolute trust, a beneficiary is absolutely entitled to the assets. If over 18 (16 in Scotland) the beneficiary has a right to demand the assets at any time.

In contrast, under the discretionary trust, no beneficiary can demand the asset.

Is the gift a CLT or a PET?

CLT stands for Chargeable Lifetime Transfer and PET for Potentially Exempt Transfer. These terms describe the tax treatment of gifts. If a gift is a CLT then it is chargeable to the lifetime transfer rate of IHT (currently 20%), during an individual's lifetime if the value of the gift is in excess of the individual's lifetime nil rate band (less any CLTs made in the previous seven years).

If a gift is a PET then it is only chargeable to IHT if the settlor dies within seven years of making the gift. The distinction is important where large gifts are made.

Are the assets in the trust protected in divorce or bankruptcy proceedings of the beneficiary?

Assets in absolute trusts are not protected from divorce or bankruptcy proceedings of the beneficiary as the beneficiary is absolutely entitled to the assets.

The assets may be protected in the discretionary trust; this is because the beneficiary only has a benefit if the trustees choose to exercise a discretion. In the case of divorce and bankruptcy the trustees can simply decide not to exercise discretion and the assets should be protected. This is, however, by no means certain in all cases.

In most circumstances, discretionary trusts should be used as this type of trust provides more flexibility and protection. However, in some circumstances the absolute version may be more suitable, for example, if you wish to make an outright gift of money to someone and do not wish to control when the individual can receive the gift.

Important

Please note trusts are not regulated either by the Financial Conduct Authority or the Prudential Regulation Authority.