TRUSTS FACTSHEET-
PROVISION FOR BENEFICIARIES WITH DISABILITIES OR SPECIAL NEEDS

A significant problem when providing for a person who has a disability or who has special need is that they may be incapable of managing large sums of money personally and they may be dependant upon means tested benefits. There may be no way of knowing how much money that person may need to make their lives comfortable nor when those monies may be needed.

There are several different types of trusts but for disabled beneficiaries usually the most useful are a fully discretionary trust or a Disabled Person's Trust. The latter is a type of discretionary trust where the use of the trust assets is largely limited to the use of the disabled person during their lifetime.

Discretionary trusts have the benefit of being very flexible as to how the capital and income of the trust fund is to be applied. The trust can be drafted quite widely, for example, to allow the trustees to make loans to a beneficiary on whatever terms they choose (so as to avoid giving capital from the fund directly to a beneficiary who may be in receipt of means tested state benefits) or the trustees could purchase assets for the trust and loan them to the beneficiary.

In addition to the disabled person that you wish to benefit primarily it is necessary that other beneficiaries are named in the trust.

With a fully discretionary trust if the trustees were to find that the disabled person had no use for the assets of the fund then these could be used in full for the benefit of the other beneficiaries and upon the death of the disabled person the trustees may use their discretion to distribute any assets remaining in the trust to the surviving beneficiaries. Obviously this flexibility carries some risk as it is possible that none of the monies are used for the disabled person if the trustees choose not to use the money for that person's benefit. It is, therefore, essential that you trust your chosen trustees to carry out your wishes and you should make your wishes clear by setting out guidance in a "letter of wishes" (although this would not be binding upon them but simply explains how you would like them to use their discretionary powers).

A Disabled Person's Trust, however, is slightly different to a fully discretionary trust as it usually provides that only the disabled person can benefit for the trust during their lifetime and then upon the death of the disabled person the trust becomes a fully discretionary trust which allows the trustees to distribute any remaining assets for the benefit of the other named discretionary trustees. The trustees will decide who is to receive what share from the trust at that point but, as mentioned above you can leave a letter of wishes explaining who you would prefer to benefit.

The other main difference between a fully discretionary trust and a Disabled Person's Trust is the way in which they are taxed. Disabled Person's Trusts are taxed as if the underlying trust assets belonged to the disabled person which avoids the harsh tax treatment that usually applies to discretionary trusts.

Unlike a fully discretionary trust where there may be payments of inheritance tax due every ten years and when money is paid out or assets transferred to the beneficiaries there are no further payments of inheritance tax due upon the trust assets (even if they are paid out to the disabled person) until the death of the disabled person. At that stage the value of the trust fund is treated as if it belonged to the disabled person outright to establish whether any inheritance tax is due and usually there will be no inheritance tax to pay at that stage if the assets of the trust are less than the nil rate band (currently £325,000). After the death of the disabled person the trust will become a fully discretionary trust but any tax can be mitigated by winding up the trust promptly after the death of the disabled person.

One of the disadvantages of a fully discretionary trust is that any income produced by the trust is taxed at the trust rate at 45% (apart from the first £1,000.00 of income which is taxed at basic rates) and there is no tax free allowance for discretionary trusts so all income is subject to tax. Any assets sold by the trust may also be subject to a higher rate of capital gains tax where they have increased in value. However, in a Disabled Person's Trust any gains are assessed as if the assets belonged to the disabled person personally and so their income tax allowances and their income tax rates apply to the trust income. It will be necessary for the trustees to declare the trust as a trust for a vulnerable beneficiary to get this preferential income tax treatment.

With both types of trust annual tax returns may need to be submitted by the trustees and the trustees must hold meetings on at least an annual basis to consider whether or not they should be exercising their discretion to distribute income or capital from the fund. They must also take independent financial advice upon the investment of the trust fund and they must keep the investments under regular review.

In a fully discretionary trust, a Capital Gains Tax (CGT) charge may arise if assets are sold or distributed to a beneficiary. A fully discretionary trust only has a £3,000 CGT allowance in comparison to an individual who has £6,000. The trust also has to pay tax at a higher rate than a basic rate tax paying individual. Provided that a Disabled Person's Trust has been declared as a trust for a vulnerable person then there is no CGT charge if assets are transferred to the disabled person and if any assets are sold the trustees can use the disabled person's CGT allowance and gains are taxed at the disabled person's own tax rates. When the disabled person dies the assets in the trust will be revalued to the date of death and any increase in value of the assets remaining in the trust at that date is effectively capital gains tax free.

The main disadvantage of a Disabled Person's Trust over a fully discretionary trust is that no-one other than the disabled person can receive any significant benefit from the trust during the lifetime of the disabled person. So, if the disabled person had no need for the assets in the fund and was unlikely to need the assets in the future they could not be distributed to anyone else until the disabled beneficiary dies.

With both a fully discretionary trust and a Disabled Person's Trust only money actually paid to the disabled person is taken into account when assessing their entitlement to means tested benefits (i.e. the whole value of the underlying fund is excluded from consideration) and this (along with the possible inability of the disabled person to manage their own finances) is one of the main reasons for using one of these types of trust rather than making an outright gift to the disabled person if they are in receipt of means tested benefits.