OHT Guide

Taxation of Discretionary Trusts

When is a Trust a Discretionary Trust?

A “discretionary trust” is defined for capital acquisitions tax (CAT) purposes in S. 2 of the Capital Acquisitions Tax Consolidation Act 2003 (CATCA 03) as follows:

> *“any trust whereby, or by virtue or in consequence of which—*
>
> *(a) property is held on trust to accumulate the income or part of the income of the property, or*
>
> *(b) property (other than property to which for the time being a person is beneficially entitled for an interest in possession) is held on trust to apply, or with a power to apply, the income or capital or part of the income or capital of the property for the benefit of any person or persons or of any one or more of a number or of a class of persons whether at the discretion of trustees or any other person and notwithstanding that there may be a power to accumulate all or any part of the income”*

The definition of a discretionary trust for tax purposes is wider than the legal definition of a discretionary trust, as a “trust to accumulate” income is treated as discretionary for tax purposes.

Finance Act 2012 extended the scope of Discretionary Trust Tax to cover “foundations” and similar entities (which are the European equivalent of trusts).

Discretionary Trust Tax (DTT)

If an asset is passed into a discretionary trust no CAT arises until the benefit is paid out so there is a delay in the payment of CAT. Discretionary trust tax is often seen as the price paid for the flexibility of a discretionary trust and the deferral of CAT.

There is an initial charge which arises at a rate of 6% on the capital value of the trust fund, on the day the trust becomes subject to the tax. The tax only arises if the settlor is dead and there are no principal objects (generally a spouse or child of the settlor) under the age of 21.

Once the initial charge arises there is a further annual charge of 1% of the capital value of the fund, arising on 31 December each year except for the year when the 6% charge falls due. If the trust is distributed within 5 years of the trigger date for the initial 6% charge then part of the initial charge may be refunded, reducing the effective charge to 3%.

Trustees are primarily liable for any DTT due on the capital value of a discretionary trust and should pay DTT as it arises.

DTT Exemptions

Revenue recognise that there may be a genuine need to provide a discretionary trust as a measure of financial protection for a vulnerable beneficiary (such as a child or an incapacitated adult). There is an exemption from DTT under S. 17 CATCA 03 where a trust is for the benefit of a named individual who is incapable of managing his affairs because of age or improvidence or physical, mental or legal incapacity. As a minor has very limited legal capacity, a trust for a named minor beneficiary will not be subject to DTT until the child ceases to be a minor (at age 18).

If a trust is set up for the settlor’s child or children there will be no DTT until the youngest child is aged 21 as each child is a principal object. However if the trust is set up for the settlor’s grandchild he is not a principal object, and the trust will be subject to DTT when the child is 18 (as the incapacity exemption ceases to apply at that age). If a trust is set up for a number of grandchildren the trust will not be exempt if one of the grandchildren is over 18 so it can be worthwhile considering separate trusts for grandchildren.

Income Tax

Trustees are liable to account for income tax on trust profits, and file trust tax returns, which are completely independent from their own personal tax returns. The standard rate of income tax applies to trustees (20% in 2020).

Where deposit interest arises to a trust and the deposit interest is subject to deposit interest retention tax (DIRT) the trustees receive income net of DIRT so tax has already been paid. Therefore, although trustees have an income tax liability if the income earned is deposit interest on which DIRT has been paid, there will be no additional tax liability.

The rate of DIRT has been higher than the standard rate of tax the trustees are subject to (20%) over the past few years. This means that the cost of paying tax via DIRT on deposit interest (currently 33%) is higher than income tax on other investments (20%). The provisions allowing for refunds of DIRT are restricted so trustees are not entitled to claim back the difference between the 33% DIRT rate and the 20% standard income tax rate.

Strictly speaking, income which is subject to DIRT is still income for tax purposes and trusts that receive interest taxed via the deduction of DIRT should still file an income tax return in relation to it.

There are also other investment products which can result in higher tax rates for trusts and these include some offshore fund products which attract a 41% tax rate.

In addition Section 805 TCA 97 provides for a surcharge on undistributed income of certain accumulation and\or discretionary trusts. If income arising to a discretionary trust has not been distributed within 18 months of the end of the year of assessment in which it arises, to a person who receives it, as income, it will be subject to an additional surcharge of 20%. Expenses “properly chargeable to income” are also deducted in arriving at the income amount subject to the surcharge and if DTT is payable, this amount can be taken as a deduction in calculating the income subject to the surcharge.

It is important for trustees to be able to show that income that arose to the trust was distributed. In practice, trustees should prepare an income schedule each year showing the income received and they should also prepare a distribution schedule each year showing the payments made to the beneficiary, separating the capital distributions and income distributions.

Income could be paid into a separate bank account, so that the income is separated from any capital held by the trust so that it could be clearly shown to Revenue, if required, that distributions come from income which arose to the trust, as opposed to payments from the trust capital.

The exemption from Discretionary Trust Tax for protective trusts has no impact on the income tax position, so trustees of a protective trust remain subject to income tax and the surcharge on undistributed income.

A beneficiary is also subject to income tax on any distributions which are received as income in the hands of a beneficiary, but the beneficiary may be able to take a credit for income tax paid by the trust (see below).

Capital Gains Tax

Trustees are liable to account for CGT on trust gains, and file CGT returns where any disposal is made giving rise to a gain for CGT purposes. The standard rate of CGT (33% in 2020) applies to trustees.

If the trust disposes of capital assets, either by selling capital assets, or by distributing capital assets in specie to the beneficiary, then the trust would be subject to capital gains tax on any rise in value of the assets from the date of acquisition to the date of disposal.

Any capital losses arising to the trustees can be attributed to the beneficiaries of the trust who receive the capital assets to which the capital loss relates if the trustees cannot utilise the loss on an earlier disposal in the same tax year. The beneficiary who receives the capital asset on which the capital loss arose can then use this capital loss against capital gains made by that beneficiary in the same year, or future years.

There is an exit charge on trustees of a settlement, which has been Irish resident or ordinarily resident, and which ceases to be resident or ordinarily resident in Ireland. S 579B TCA 1997 provides for a deemed disposal of "defined assets" at open market value immediately prior to the trustees becoming non-resident.

CAT for Beneficiaries

Capital Acquisitions Tax (CAT) is a tax on gifts or inheritances. Assets passing out of a discretionary trust settled on or after 5 December 1999 will be within the charge to CAT where:-

- the disponer (i.e. the person that settled the trust property) was resident or ordinarily resident in Ireland
- the donee or successor is resident or ordinarily resident in Ireland, or
- the property appointed is situate in Ireland.

CAT arises when a beneficiary becomes entitled to a benefit, so if assets pass into a discretionary trust this has the effect of deferring the CAT payment until the asset is appointed from the trust to the beneficiary.

If the benefit passing out of the trust takes the form of income in the hands of the beneficiary, rather than capital, then it is subject to income tax in the hands of the beneficiary. The nature of payments from a discretionary trust are discussed in more detail below. CAT is also chargeable on such a distribution from a discretionary trust and in practice, CAT is generally charged on the net of income tax amount.

The CAT regime (threshold and rate) is set by the date of inheritance. This is normally the date of death where a benefit passes via an estate.

However where the benefit comes from a discretionary trust the provisions of S. 3(2) CATCA03 have the effect of deferring the date of inheritance until a payment is made from the trust, so the threshold and rates that apply at the date of appointment are applicable.

Characterisation of Distributions

The tax treatment of distributions from a discretionary trust (either a Will trust or an inter vivos trust) depends on whether the payment comes from trust income or trust capital, and whether it is received by the beneficiary as income or capital.

1. A payment received as income by a beneficiary and paid from trust income is subject to income tax in the beneficiary's hands, with a credit for the trust income tax paid. A beneficiary is also technically subject to CAT on the income payment and Revenue will generally concessionally take the net of income tax payment as the amount subject to CAT.

2. A payment received as income by a beneficiary and paid from trust capital is subject to income tax in the beneficiary's hands and the trustee would have a withholding tax obligation. As with income paid from income, a beneficiary is also technically subject to CAT on the income (net of income tax).

3. A payment received as a capital payment by a beneficiary and paid from trust income is subject to CAT (with no income tax for the beneficiary) and there is no credit for the trustee's income tax.

4. A payment received as a capital payment by a beneficiary and paid from capital held by a trust is also subject to CAT in the beneficiary's hands.

Source of Funds

A trustee and beneficary need to look at:-

- The nature of the payments in the beneficiary's hands (received as income or capital)
- The source of the payments within the trust (from trust income or trust capital)

Nature of Payments

The nature of a payment is determined by its treatment in the hands of the beneficiary, not by the nature of the asset held by the trust.

In other words the trustee can hold capital of €100,000 and use it to pay €1,000 a month to a beneficiary which will be received as income by the beneficiary.

The dividing line between income and capital in the beneficiary's hands is not set out clearly in legislation so there is a reliance on case law principles. The following is a note of the characteristics that differentiate capital distributions in a beneficiary's hands from income distributions in a beneficiary's hands.

Characteristics of capital

1. Large once off payments tend to be capital.
2. Payments to meet once off expenses tend to be capital.
3. If funds held as capital are used to pay personal beneficiary expenses the payment is likely to be capital.
4. Payments to meet extraordinary on-going expenses are likely to be capital.

Characteristics of income

1. Periodic or regular payments tend to be income.
2. Payments of ordinary ongoing day to day living expenses tend to be income.
3. There is case law indicating that if the income a beneficiary has is insufficient to meet day to day living expenses then “top up” payments from capital will be treated as income in the beneficiary’s hands (Cunard’s Trustees v CIR).

The question of what constitutes ordinary day to day living expenses can be quite subjective.

Summary re Appointments

Source of Funds	Type of Payment	Tax for Trustee	Tax re Benefit	Credit	Forms
Capital	Capital	CGT	CAT	None	None
Capital	Income	CGT	Income Tax*	Yes	R185**
Income	Capital	Income Tax	CAT	None	None
Income	Income	Income Tax	Income Tax*	Yes	R185**

**Where an appointment is made from a trust which is subject to income tax, Revenue may also seek CAT on the benefit (net of income tax).*

***The Form R185 should be given to the beneficiary receiving the payment from the trust.*

Where income is paid from capital the trustee should also make a payment to Revenue of 25% of the amount paid to the beneficiary (effectively grossing the payment up at the 20% standard rate of income tax).

If income (in the beneficiary’s hands) is paid from income there is no withholding tax payment to be made to Revenue, provided the trustees have paid their income tax when due.

Stamp Duty

Where assets are transferred to a discretionary trust on death, then no stamp duty charge arises, and no stamp duty charge arises on the appointment of assets from the trust to a beneficiary.

If a disponer settles assets into a discretionary trust during his lifetime then there would be an exposure to stamp duty on settling the assets into the trust, but there should be no stamp duty charge on an appointment to beneficiaries of the discretionary trust.

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Caveat: *These notes are intended as a general guide to taxation of discretionary trusts. OHT has endeavoured to provide an accurate commentary but the notes cannot cover all circumstances so OHT strongly recommends that formal tax advice be obtained before any steps are taken that may have a tax effect. It should also be noted that the Revenue approach may change over time and that the relevant legislation may be amended.*

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