

Discretionary trusts guide

Using Trusts in wealth planning

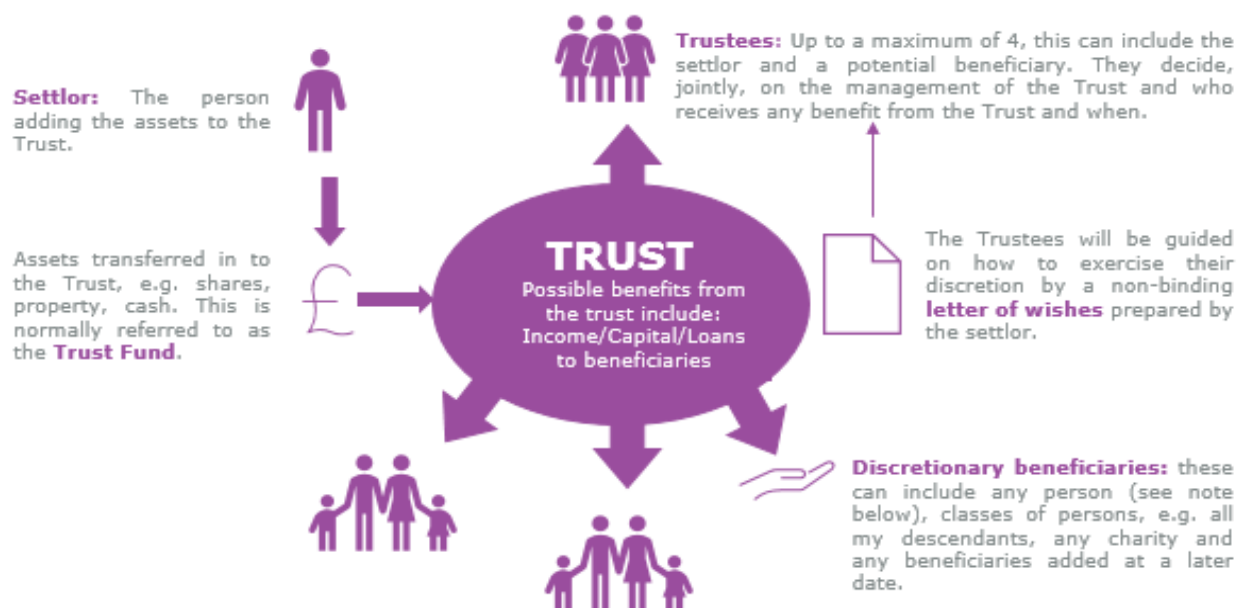
Where people wish to pass money on to future generations they are often concerned about:

- Their hard-earned wealth being diverted to people they did not intend, for example, being included within a grandchild's divorce settlement!
- Loss of control. This could especially be the case where important assets are being given away, such as property or shares in a business. Whilst they wish to give away their value they would like to retain a degree of control in order to ensure the property or business is maintained and managed in an appropriate way.
- Avoiding too much capital being at the disposal of someone who may be too young (e.g. grandchildren), vulnerable to exploitation or may be financially immature.
- Protecting wealth that is gifted should the recipient be at risk of bankruptcy or other financial risks.

For the reasons above Trusts can be an extremely valuable tool when considering passing on wealth.

What is a Trust

At Clarion we love to use diagrams to explain concepts and avoid the legal jargon our clients often dislike. There are different types of Trust, this guide relates to discretionary trusts which are the most common type of Trust we prepare. A discretionary trust can be viewed as follows:



Points to consider when creating a discretionary trust

Your lawyer will of course guide you through the various steps involved in making your Trust but you may find the points below help you consider how to structure your discretionary Trust.

Trustees: Using a company structure analogy, these are akin to the directors in a company structure. Together, they decide on the management of the Trust, including management of the underlying assets (e.g. instructing an investment manager if shares are traded and/or voting on company matters where voting rights are associated with the shares). The settlor, the person providing the Trust assets, can also be a trustee. Fundamentally the trustees must be trustworthy people who will carry out the settlor's wishes when they are no longer alive.

Letter of Wishes: This sets out what should happen to the Trust Fund in the longer term. Whilst the settlor is alive they can obviously make their wishes known to the Trustees but it is very helpful to have a record of their wishes should they lose mental capacity or die. This could include:

- when beneficiaries should receive payments and how (e.g. a loan or income payments)
- who could be added as a trustee in the future
- who could be a trustee in the future if the original trustees were unable to continue
- how the Trust Fund should be managed, for example, guidance on voting with respect to company shares, or when it may be appropriate to sell the shares
- how the trust should end (the Trust can exist for a maximum of 125 years)

Discretionary beneficiaries: You need to define, when the Trust is created, who may potentially benefit from the Trust Fund. Using the company structure analogy again, the beneficiaries are akin to the shareholders in a company, however, the key point here is that these people are only potential beneficiaries and have no rights to the Trust Fund. The beneficiaries can be defined by names, descriptions (e.g. all my descendants) and can also include organisations such as charities. Given the Trust could exist for 125 years it is important to consider having the power to add beneficiaries later, either by the settlor or by other people, such as the Trustees or perhaps the existing discretionary beneficiaries.

Excluded beneficiaries: For inheritance tax purposes the settlor and their spouse are normally excluded from receiving any benefit from the Trust. Specific advice should also be sought on who should be excluded as a beneficiary to avoid issues in respect of income tax and capital gains tax.

How beneficiaries receive a benefit: The letter of wishes referred to above outlines who the settlor would like to receive a benefit from the Trust. Generally, Trustees will have wide powers to provide different types of benefit. For example, it may be that some beneficiaries receive income direct from the Trust (mandated income). This can help in respect of taxing the income at the beneficiary's income tax rate rather than the Trust's income tax rate which is likely to be higher. Any decision to pay income in this manner would be revocable at the trustees' discretion.

In addition to outright payments of capital from the Trust Fund the Trustees can authorise loans to be made to beneficiaries, either on commercial terms or on 'family friendly' terms with little or no interest. The benefit of a loan is that if the beneficiary's circumstances change, meaning their capital is at risk, the Trustees could call-in the loan. Loans can also be advantageous if the beneficiary has their own inheritance tax liability. By using the loan route not only is the settlor carrying out tax planning for themselves, they are opening up tax planning opportunities for the next generation.

Case Study – The Grandparent Trust

Grandparents wish to benefit their grandchildren but also wish to avoid making a large gift outright to them. Each grandparent therefore creates a discretionary trust with themselves as Trustees. The Trust holds shares in a trading company (either issued directly to the Trustees or gifted to the Trustees by the grandparents).

The Trustees, having regard to the income tax rates applicable to a discretionary trust, the lower tax rates applicable to the grandchildren and their education needs, exercise their discretion to mandate the income to some of the grandchildren. By doing so, the dividends generated by the shares are taxed in the grandchildren's hands at their lower income tax rate. This income can then be used in order to meet the needs of the grandchildren, for example, their school fees. The capital value of the shares remains in the Trust pending any decision by the Trustees to distribute the shares at some future point.

Later, should it be necessary, the income feed from the Trust can be stopped by the Trustees revoking the income mandate and instead directing it to another beneficiary or leaving it to accumulate in the Trust. This can be very helpful where a grandchild has 'gone off the rails' or is in some way vulnerable to exploitation. Changing the income can also be helpful where another grandchild

arrives and the income streams need to be re-aligned or where the grandchildren begin to have different income requirements. The information in this guide is intended as guidance only and does not constitute specific legal advice. If you require specific legal advice in relation to your circumstances, please contact a member of the Private Wealth Team at Clarion.

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