Countrywide
TAX AND TRUST CORPORATION LTD

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Benefits of Discretionary Trusts

This technical note clarifies the key features and benefits of discretionary trusts.

Key Learning Points
1. Discretionary Trust explained
2. Benefits of using a Discretionary Trust
3. Memorandum of Wishes
4. Loans
5. Summary

Discretionary Trust explained

A Discretionary Trust is a trust which gives Trustees broad power of discretion when it comes to the question of what they can do with the trust assets. For example, they can make outright payments, loan money, invest money, or even take no action at all.

All beneficiaries named in the trust are 'Potential Beneficiaries' so do not have a right to any benefit from the Trust. The potential beneficiaries, in the eyes of the law, simply have a hope or wish that the Trustees will advance some form of benefit from the Trust.

This serves to protect the Trust assets as far as possible for the beneficiaries from creditors, taxation, means testing or other risks, but remain available as required and as intended by the Settlor(s).
The broad discretion of the Trustees is guided by the Memorandum of Wishes which the Settlor prepared during his/her lifetime.

Benefits of using a Discretionary Trust

Discretionary Trusts have been widely used for centuries and the advantages of managing them correctly are huge. Assets that are part of a discretionary trust and managed correctly do not form part of the estate of the 'Potential Beneficiaries'. The fact that they are 'potential' beneficiaries is key in that they do not have a 'right' to the assets within.

This doesn't mean that they will get less once the Settlor passes away, as the trust has been put in place for their benefit, but it is at the Trustees' discretion which is key. The Trustees, therefore, have the overriding say in who should benefit and under what terms and we would always champion the use of 'loans' as opposed to 'outright distributions' as discussed below. Better still, the Trusts make investments say into a share of a property.

Hence, the Trust monies used and any income or gains are retained by the Trust and for its intended beneficiaries. Here the gain remains protected along with the initial Trust capital, whereas a loan out means that the Trust may not benefit from the growth or income from any asset it is used to purchase and also less is then protected from certain taxation.

The Trustees are directed via the Memorandum of Wishes, which they should consider in making their decisions.

Provided the trust is managed correctly, the assets of the Trust should not form part of the estate of the named beneficiaries, which means that the beneficiaries can be protected as much as possible from the following threats:

i. Divorce
ii. Bankruptcy
iii. Creditor Claims
iv. Long Term Care Fees
v. Multi-Generational Inheritance Tax (IHT)

Memorandum of Wishes

The broad discretion of the Trustees is guided by the Memorandum of Wishes which the Settlor prepared during his/her lifetime. This is a non-legally binding document that sets out the Settlor's hopes on how they might have liked the Trustees to exercise their powers.

However, as it is not binding on the Trustees, they can stray from the document as far as they think suitable, considering the best interests of the Trust, tax consequences and any moral claims by the beneficiaries.

Loans

When funds are loaned from the Trust, the money is transferred to the beneficiary and they can do with this what they would like. However, this money is due back to the Trust and can therefore be recalled by the trustees if the beneficiary owed money to third party creditors, as a result of bankruptcy or divorcing parties noting the points made in the 'Benefits of using a Discretionary Trust' section above.

The funds would also be repayable to the Trust on the death of the Beneficiary and this means that the Trust can continue for future generations. This amount is also not part of the beneficiary's estate for Inheritance Tax purposes, mitigating a potential 40% tax liability on these amounts.

Summary

• Correctly managed Discretionary Trusts provide protection of assets for the beneficiaries and this type of trusts are always used where possible to offer maximum protection of assets.

• Beneficiaries of a Discretionary Trust are only 'Potential Beneficiaries' and in the eyes of the law, simply have a hope that Trustees will advance some benefit to them.

• Trustees have absolute discretion when it comes to the question what they can do with the trust assets and they are guided by the Memorandum of Wishes drafted by the Settlor.

• Trustees would normally document the distribution of assets in a form of a Loan to ensure the on-going protection of assets.