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THE SPEAKING ARROW

Family Trusts – An overview

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SURESH & CO.
Chartered Accountants

#43/61, "Srinidhi",
Surveyor's Street,
Basavanagudi,
Bengaluru – 560 004

E: info@sureshandco.com
W: www.sureshandco.com
P: 080-2662 3610/11

Introduction

A family trust is a trust created to benefit persons who are related to one another by blood, affinity, or law. It can be established by a family member for the benefit of the members of the family group. Family trusts acts as an instrument to pass on the assets to future generations. Most important purposes of considering a Trust is towards wealth protection, succession planning for family and transfer of assets primarily for the welfare of the family members, both during and after the lifetime of settlor.

Family trusts are very effective and convenient, and if used prudently can be a great tool not only for succession planning, but also for managing assets, finances and investing in securities and utilizing the returns earned by the trust for the benefit of the beneficiaries. A family trust can also be utilized to provide for specific needs of the family, say education or health or travel or marriage and in itself act as a vehicle which holds assets only for that specific purpose, multiplying, safeguarding, managing and securing them for that outlined purpose.

Effective estate and wealth planning ensure that families retain control over their businesses and a smooth transition of leadership of businesses between generations of families. It balances the needs of businesses with the interests of family members. Effective planning of the wealth of high net worth individuals can prevent long and expensive legal disputes between heirs based in multiple jurisdictions. Various structures provide different degrees of control over the purpose for which the wealth can be used and the manner in which it may be used. One of the most commonly used structures to manage personal assets, including both tangible assets as well intellectual property, and succession planning is the private family trust.

Objectives and importance of setting up Family Trust

- Create a suitable framework for efficient and easy management of assets through the trust route to meet the requirements of the family members;
- Consolidation of assets for ease of administration;
- To enable transfer of assets to the family members in most efficient and a phased manner;
- To achieve a practical balance between control and ownership of family business;
- To insulate the family from liabilities which may arise from unfortunate event (ring fencing of assets);
- To minimize the possibility of any family disputes, or conflicts within the family. The family arrangements / family settlements over various assets including business assets can be structured through the family trusts, and this would avoid disputes among the subsequent generation family members in future;
- Administrative ease of usage and management of assets post demise of key family member, especially where the beneficiaries are in different parts of the globe;
- Tax Optimization for the beneficiaries located in different tax jurisdictions;
- Protection from marital disputes;
- Protection from possible legal disputes and claims over assets through Will (testament);
- Protection of interest of special children and transition of assets to 3rd or subsequent generation over a period of their maturity.

Succession planning through private family trust, allows the author to have complete control over the trust and freedom to pass on the assets to the beneficiaries, which can be set out in the Trust Deed by the author. There is greater flexibility for appointment of Trustee/(s) for managing, maintaining, and holding the assets of the trust for the benefit of the beneficiaries. The trustee may be a beneficiary, family member, relative or there can even be a professional trustee appointed for the management of the trust. The author can also be one of the trustees or the managing trustee of the trust. Since there is no control by the author over the management and assets of the trust, the assets, held in trust are safeguarded from any action by creditors, and thus, the family members' interest in the trust's assets (being the beneficiaries) continue to remain safeguarded in the event of any legal action against the author.

A private trust offers several advantages, not the least of which is ring-fencing of assets against possible losses due to business liabilities, family related liabilities arising from divorce / maintenance claims, tax claims, re-introduction of estate duty in India, and / or actual or potential creditors. It also provides a mechanism whereby the needs of the entire family are met, including the future needs of young or unborn children / grandchildren, while allowing the flexibility to provide appropriate benefits to different family members at different points in time, taking into account changing necessities, opportunities, etc., and contributions made by such members for the well-being of the family. While private trusts may be managed by family members, they also provide the flexibility to appoint an unbiased independent person for taking decisions on distribution of wealth to various family members and others.

Wealth Holding (Form of assets)

- Financial Assets (including shares, mutual funds, bank balances, investments, deposits etc.).
- Immovable properties across India.

Basic Concepts of Family Trusts

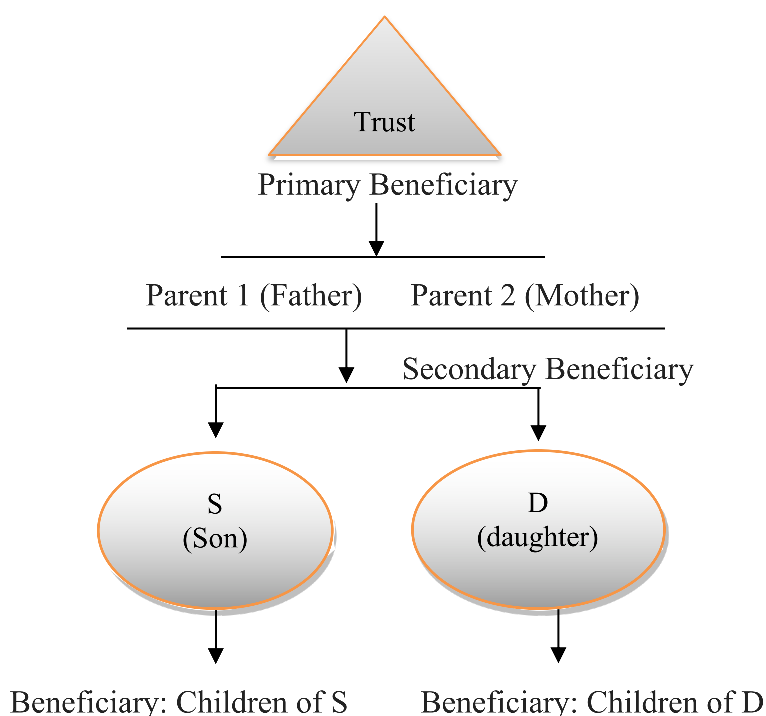
- **Trust:** A Trust is a fiduciary structure set up for vesting or placing property under the control of a person in the confidence that they/it will hold it for the benefit of the family members (beneficiaries).
- **Settlor/Grantor:** The settlor must be an independent person who creates the trust by placing a certain unencumbered asset that he owns into the Trust, i.e. by transferring that asset to another person (trustee) along with clear instructions that the asset be held for the benefit of a third party. There can be more than one settlor to a Trust.
- **Trustee:** The trustee is responsible for all compliance and administrative responsibilities and takes care of all fiduciary responsibilities. The trustee owes a duty of care of good faith to the beneficiaries and act in the best interests of all beneficiaries. The Trustee is responsible to look after trust funds by investing & managing it and distributing the income to various beneficiaries at the end of each financial year. The Trustee must also maintain books of account and lodge relevant income tax returns with the tax office.
- **Trust Advisor/Protector/Advisory Board:** The trust may have Trust Advisor, who will advise the Trustee on various administrative matters like investments, disbursements etc.
- **Beneficiary:** The beneficiary is a person for whose benefit and profit the trust asset is held and managed by the trustee. The beneficiary or beneficiaries may be either specifically named in the Trust Deed or may be a sufficiently defined group of persons (for example "all children and grandchildren"). A settlor can also be named as beneficiary of the trust. In most of the trust deeds "initial beneficiaries" are noted in a schedule and are usually family members or other close relatives. There are classes of beneficiary who can be parents, grandparents, brothers, sisters, children, grandchildren, aunts, uncles, nephews, and nieces of initial beneficiaries.
- **Primary beneficiary:** Primary beneficiary is the first party to benefit from the trust. The assets/income in the trust would go to primary beneficiary when the trustor (The person who creates a trust also called as Settlor) dies or otherwise loses his/her rights to the trust's holdings.
- **Secondary beneficiary:** A secondary beneficiary is a person or entity that inherits assets under a will, trust or insurance policy if the primary beneficiary dies before the grantor. Also, sometimes called as a Contingent Beneficiary.
- **Changing beneficiary:** The trust beneficiary can be changed as and when required, in case of a revocable trust. In case of irrevocable trust, changing the beneficiaries is much harder as it may require judicial approval etc.
- **Trust Deed:** A document, including amendments thereto, executed by the Settlor that contains terms under which the trust property must be managed and distributed. Also referred to as a trust agreement or declaration of trust. Trust deed outlines the purpose of the trust, and details of rights and obligations of the trustees and beneficiaries.

  Also trust deed identifies various parties such as Beneficiaries, Trustees and Appointor etc.

- **Revocable trust**: Revocable trust is created during the lifetime of the settlor and can be altered, changed, modified or revoked entirely. Often called a living trust, these are trusts in which the settlor transfers the title of a property to a trust, serves as the initial trustee, and has the ability to remove the property from the trust during his or her lifetime. Revocable trusts are extremely helpful in avoiding probate. Probate means, if settlor made a will and when he dies, his estate must go through a legal / court process and for this process it's called as probate. Although useful to avoid probate, a revocable trust is not an asset protection technique as assets transferred to the trust during the settlor's lifetime will remain available to the settlor's creditors. Typically, a revocable trust evolves into an irrevocable trust upon the death of the settlor.
- **Irrevocable trust:** An Irrevocable trust is one which cannot be altered, changed, modified or revoked after its creation. Once a property is transferred to an irrevocable trust, no one, including the settlor, can take the property out of the trust.
- **Discretionary trust**: In a discretionary trust, the beneficiaries would be identifiable upfront, but the quantum of their beneficial interest is decided by the Trustee subsequent to formation of the trust.
- **Non-Discretionary Trust:** In a non-discretionary trust, the trustee does not have or have restricted powers to determine the amount to be distributed to the trust's beneficiary. Trustee must follow the terms of distribution set out in the Trust Deed.
- **Letter of Wishes - (LOW):** It is a document capturing the indication by the Settlor of the manner in which he/she wishes the trustees to exercise their discretion in relation to a trust. This is a guidance provided by Settlor and not an obligation on the trustee to follow.

Trust structure – Explained with an example

- The Trust deed lays down the basic terms and objectives of the Trust. The rights and obligation of the Settlor, Trustee, Protector & Beneficiaries.
- Full control of the trust would remain with the Settlor and only upon demise or incapacitation of the Settlor, the role of the Protector would come into force.
- The Protector's role as decided by the Settlor, can guide the Trustees on functioning of the Trust.
- The Trustee manages the affairs of the Trust.
- The Trustee makes income or corpus distribution only to the beneficiaries based on the terms mentioned in the Trust Deed on the instruction of the Settlor or Protector



General points about a family trust

- All categories of assets can be settled/ transferred/contributed in the Trust. However, there may be stamp duty impact (depending on the state) on transfer of immovable property to a Trust. Therefore, it will be cost effective to settle/transfer financial assets in Trust. Immovable property can be routed through a Will that becomes effective upon the demise of Testator (A person who has given made a Will or given a Legacy).
- In case of a revocable trust, there could be applicability of estate tax if it is introduced (in future) in India. In the US, estate tax is already in force. Estate tax is the tax levied on property and money acquired by gift or inheritance.
- The drawback of an irrevocable trust is that once the Settlor/Grantor establishes an irrevocable trust, he loses the legal ownership of trust properties. The trustee holds them on behalf of the trust beneficiaries. The grantor is not allowed to revoke an irrevocable trust. An irrevocable trust can be revoked only by court order, based on established legal ground

Trust concepts:

There are three types of Trust:

- Revocable trust
- Irrevocable Determinate trust
- Irrevocable Indeterminate trust

A comparative table on features of the aforesaid three types of trust are as follows:

Sl. No.	Features	Revocable Trust	Irrevocable Determinate Trust	Irrevocable Indeterminate Trust
(i)	**Meaning**	A Trust where the right to revoke/close the Trust at any point of time is available with the Settlor.	A Trust which cannot be modified or terminated by the Settlor. A Determinate trust is one where both beneficiaries and their beneficial interest are defined.	A Trust which cannot be modified or terminated by the Settlor. An Indeterminate Trust is one where only beneficiary is defined but the beneficial interest of each beneficiary is not determined.
(ii)	**Registration of Trust**	Compulsory only in case of immovable property being housed in the Trust.	Same implication as Revocable.	Same implication as Revocable.

Sl. No.	Features	Revocable Trust	Irrevocable Determinate Trust	Irrevocable Indeterminate Trust
(iii)	**Tax implications:**			
(a)	Income Tax	Income generated is taxed in the hands of the Settlor. The Settlor will file the Income tax return in his own name. The Trustee will prepare an Income & Expense statement for the Trust and shall hand it over to the Settlor.	All such income received will be taxable in the hands of the beneficiaries.	Income is taxed at Trust level. The Income tax return will be filed by the Trust. Income will be taxed at Maximum Marginal Rates (i.e. highest rates)
(b)	Taxation of Gift	As distribution of the income or assets by the Trust would only be to the relatives as defined under exempted category of gifts, the same may not be subject to income tax. [Section 56(2)(x) of the Income Tax Act]	Same implication as Revocable.	Same implication as Revocable.

CONTACT US

SURESH & CO.

#43/61, Surveyors Street, Basavanagudi,

Bangalore-560004

P- (080) 2662 3610/11

E- info@sureshandco.com

W- www.sureshandco.com

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Compiled by: Srinivasan A and Vishal Purohit

A Kiran Manager Tax kiran.a@sureshandco.com +91 99803 88722	Arun Kumar S Principal Consultant arun.s@sureshandco.com +91 99019 71333
D S Vivek Managing Partner vivek.sureshandco.com +91 98453 78991	Udupi Vikram Partner vikram.u@sureshandco.com +91 97387 79117

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