



DISCRETIONARY GIFT TRUST TECHNICAL GUIDE

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In this document the term “spouse” includes a reference to a registered civil partner under the Civil Partnership Act 2004



1. OBJECTIVES AND SUITABILITY OF THE TRUST

The aim of the Discretionary Gift Trust is to facilitate effective lifetime inheritance tax (IHT) planning for an investor in a London & Colonial Offshore Open Bond (the “Bond”). The Discretionary Gift Trust can be used in connection with both existing Bond investments and with cash intended for an investment in a new Bond. By using the Discretionary Gift Trust an investor (who is the Settlor of the trust) will be making a gift of (in the case of an existing Bond) the Bond or the funds intended to be invested in the Bond. When the gift is of cash, the Trustees will make an application for the Bond which will be issued to the Trustees as the policyholder.

The gift described above will be a chargeable lifetime transfer (CLT) for IHT purposes to the extent that the amount gifted (or the value of the existing Bond) exceeds the Settlor's available annual exemption(s). However, if the value of the gift (less any annual exemption(s)) plus the value of all CLTs made by the same Settlor in the seven preceding years does not exceed the Settlor's nil rate band for IHT purposes (£312,000 in tax year 2008/09) there will be no actual liability to IHT. If the nil rate band is exceeded, there will be a liability to IHT at 20% on the amount of the gift that causes the Settlor to exceed his/her nil rate band. It is generally recommended that gifts are not made during lifetime in excess of the nil rate band so as to avoid giving rise to any lifetime IHT liability.

If the Settlor dies within seven years of making the gift, the liability would need to be recalculated at death rates (see section 5 for a full explanation).

To ensure that the Discretionary Gift Trust is effective for IHT purposes, the Settlor cannot benefit under the trust in any circumstances.

Full details of the UK taxation implications of the Discretionary Gift Trust can be found in section 5.

As well as providing important tax benefits, because the Bond is held subject to the Discretionary Gift Trust it will not be an asset of the Settlor's estate for probate purposes.

The Discretionary Gift Trust can be used regardless of whether the Bond already exists or is to be effected by the Trustees. The person creating the trust is known as the Settlor and where two persons are making the gift to the trust, they will be joint Settlers.

If the Settlor is the sole life assured under the Bond, the Bond would automatically encash on his/her death. To avoid this automatic encashment, it is usually recommended that any new Bond being effected by the Trustees should be effected on the lives of two or more persons, for example the Settlor, his or her spouse and/or children on a last survivor basis. This could provide greater flexibility as to the time of the final encashment of the Bond and could avoid an encashment at a time that is unsuitable for either investment or tax reasons.



2. INHERITANCE TAX PLANNING USING THE TRUST

As stated above, to ensure that the Settlor makes an effective gift for IHT purposes, the Settlor must not retain any benefit (actual or prospective) under the trust. As a result, the Settlor is excluded from all benefit under the Discretionary Gift Trust. However, the Settlor can retain considerable legal control over who will benefit from the trust fund during his lifetime. This is because, as well as being one of the Trustees, the Settlor will also be the Appointor under the trust. This means that he or she (or they) have the power to appoint the benefits from the trust amongst any of the Discretionary Beneficiaries specified in the trust. After the Settlor's death the power of appointment passes to the Trustees.

The retention of the power of appointment by the Settlor does not give rise to a gift with reservation because the Settlor cannot exercise the power in his own favour.

When the trust is declared by one Settlor, the inclusion of the Settlor's spouse as one of the Discretionary Beneficiaries does not constitute a gift with reservation. However, if any benefits are actually paid to the Settlor's spouse during the lifetime of the Settlor, extreme care must be exercised. Should the Settlor exercise the power of appointment in favour of his/her spouse, who is one of the Discretionary Beneficiaries under the trust, and trust benefits are paid out to the Settlor's spouse, it is absolutely essential that no part of these benefits finds its way back to the Settlor. If this were to happen, the trust could be seen as one under which the Settlor reserved a benefit and, because of the gift with reservation rules, would make it ineffective for IHT purposes. Of course, in a joint Settlor case (where both spouses are the Settlers) such an appointment to a spouse would not be possible as both the Settlers would be excluded from all benefit under the trust.

An appointment to the Settlor's spouse during the Settlor's lifetime should therefore be approached with extreme caution.

As the trust is a discretionary trust, no Beneficiary is entitled to any benefits until the Appointor makes an appointment in his or her favour. Until recently, where the investor wished to make a gift of his investment, a typical trust used with a Bond would have been a flexible interest in possession trust. This was popular because gifts to such trusts (to the extent that they were not exempt) were treated as potentially exempt transfers (PETs) which meant that a potential IHT liability could only arise if the Settlor died within seven years of making the gift. Since 22 March 2006, the scope for making PETs has been severely restricted. Only outright lifetime gifts to individuals or to bare trusts and trusts for the disabled are now treated as PETs. All other lifetime gifts to trusts, including gifts to the Discretionary Gift Trust, are CLTs. However, this does not mean that any actual tax liability will arise – see below.

A discretionary trust would be suitable where the Settlor is not prepared to commit to a gift to any particular named Beneficiary and wishes to retain flexibility over who will ultimately benefit from the trust. The "price" to pay for this flexibility is that special IHT charging rules will apply. However, no actual charge to IHT will arise when the trust is established provided the gift to the trust does not cause the Settlor (or Settlers) to exceed his or her (or their) then available nil rate



band(s). Charges can also arise on the discretionary trust fund every ten years (periodic charges) and when property leaves the discretionary trust (exit charges) although, in practice, even if a charge does arise, it should not be substantial. These charges are explained in detail in section 5.

When an investor requires some beneficial access to the Bond, the Discretionary Gift Trust should not be used as under this trust, as explained above, the Settlor is excluded from all benefit.

For detailed consideration of the IHT implications of the Discretionary Gift Trust see section 5.

3. THE LONDON & COLONIAL DISCRETIONARY GIFT TRUST AND PROBATE

To ensure that there is no need to include the Bond as part of the Settlor's assets for probate purposes, when the Settlor dies, the legal ownership of the Bond must be with a person or persons other than the Settlor at that time. This is achieved by having the legal ownership of the Bond vested in Trustees. However, this benefit will only be secured if there is at least one Trustee who survives the Settlor because otherwise probate will be necessary to determine the Trustees (see below). Under the Discretionary Gift Trust the Settlor is automatically one of the Trustees and additional Trustees are appointed in the trust deed. If any of the additional Trustees retires or dies before the Settlor, a replacement Trustee or Trustees should be appointed.

If there is no surviving Trustee on the death of the Settlor (because the additional Trustees have died earlier or been removed or retired), the Settlor therefore being the only Trustee at the time of his or her death), the trust will nevertheless continue to exist but with the personal representatives of the deceased Settlor assuming the role of Trustee under the Discretionary Gift Trust. This means that although the Bond will not form part of the Settlor's estate for IHT or probate purposes, it will be necessary to secure probate or letters of administration to the Settlor's estate to ensure that the personal representatives can act as Trustee under the Discretionary Gift Trust. This is why it is very important that additional Trustees are appointed who are likely to survive the Settlor so as to ensure that on the Settlor's death there are no delays in being able to deal with the Bond.

4. THE LONDON & COLONIAL DISCRETIONARY GIFT TRUST PROVISIONS IN DETAIL

The Discretionary Gift Trust gives the Appointor (the Settlor during his lifetime and the Trustees after the Settlor's death) power to appoint benefits under the trust among a wide class of Beneficiaries which includes the Settlor's spouse (unless that spouse is also a Settlor). No Beneficiary is entitled to any benefit until the Appointor decides. The ultimate Default Beneficiary(ies) named in the trust will benefit only if no other appointment has been made by the end of the Trust Period, an unlikely event. The fact that the trust is a discretionary trust means that its assets are not in the estate of any Beneficiary for IHT purposes.

The following is a summary of the key provisions as they appear in the draft Discretionary Gift Trust provided by London & Colonial.



Part 1 - Declaration

The trust offers alternative provisions depending on whether the gift is of cash or of an existing Bond.

The cash gift will normally be satisfied by the Settlor giving a cheque payable to London & Colonial to the Trustees. The application for the Bond will be made by all the Trustees.

If an existing Bond is being transferred to the trust, the deed incorporates a legal assignment of the Bond to all the trustees.

Part 2 - Definitions

In this part of the trust the terms used throughout the trust are defined to avoid repetition. The most important definitions are those of the Discretionary Beneficiaries and the Default Beneficiaries.

The Discretionary Beneficiaries are those persons to whom the Appointor under the trust (the Settlor during his or her (their) lifetime and thereafter the Trustees) may appoint benefits. They include the spouse (except where the spouse is a joint Settlor), widow or widower of the Settlor, the children and the remoter issue of the Settlor, their spouses, the brothers and sisters of the Settlor and their issue, anybody who would benefit from the estate of the Settlor on the Settlor's death as well as any person nominated in writing to the Trustees by the Settlor as well as any charity. The class of Discretionary Beneficiaries is therefore very wide and can be added to by the Settlor - all that is necessary is a written notification to the Trustees. However, the Settlor himself/herself cannot be added to the class at any time.

The Default Beneficiary(ies) is the individual/individuals who will benefit in the unlikely event that the power of appointment is not exercised by the Appointor by the end of the Trust Period. This is defined as the longest period allowed under English law – currently 80 years from the time the trust is created, but there are proposals to increase this to 125 years. They are named by the Settlor in the trust deed. At least one person must always be named and if more than one is named, the shares in which they are to benefit must be stated. This is necessary to ensure that the trust has the desired effect.

Part 3 - Principal trust terms

In this part the **power of appointment** is defined as well as **the default entitlement** if the power of appointment is not exercised.

As mentioned above, the power to appoint capital and income under the trust is vested in the Appointor - that is the Settlor(s) during his/her/their lifetime and thereafter the Trustees. The power is exercisable at the Appointor's discretion and includes the power to appoint further trusts in favour of Beneficiaries.

Where there are two Settlers, the Appointor will be both Settlers whilst alive and then the survivor of them. After the death of the Settlor(s) the Appointor will be the Trustees.



The Trustees have power to accumulate any trust income for 21 years from the date of the trust – this is the maximum accumulation period currently allowed under English law.

In default of an appointment of all trust assets being made by the end of the Trust Period, the Default Beneficiaries will benefit. These are the people initially named by the Settlor in the trust deed. In practice it is most unlikely that the trust fund will not be distributed within 80 years.

There is also a special provision dealing with any potential conflict of interest. In many cases the Trustees of the trust would be family members who would also be Beneficiaries under the trust. If the power of appointment were to be exercised by the Trustees (after the death of one or both Settlers) such Trustees would often also be the Beneficiaries (for example the spouse and/or children of the Settlor) and if an appointment of benefits were to be made in favour of a Beneficiary who is also a Trustee then suspicion of a conflict of interest could arise. For this reason there is a provision in this trust which states that if a Beneficiary is also one of the Trustees, the Trustees can only make an appointment in favour of that Beneficiary if there is at least one other Trustee who does not benefit directly or indirectly from the appointment being made.

The Trustees have wide powers to advance capital from the trust fund to the Beneficiaries and to make loans to Beneficiaries. In particular, the power to lend may give rise to tax planning opportunities where, after the Settlor's death, the Settlor's widow/widower requires funds from the trust but there is a desire to reduce the potential IHT liability on his or her subsequent death. In such a case the Trustees could make an encashment or withdrawal from the Bond (see section 5 for the tax consequences of this) and make an interest-free loan, repayable on demand, to the widow/widower. Provided the loan is fully spent, the widow/widower's taxable estate would not increase but because the loan is repayable on his/her death it would then effectively reduce the net estate of the borrower for IHT purposes. If the Settlor's surviving spouse needed cash after the Settlor's death, it may then be appropriate to consider a loan to him/her.

One word of warning should be heeded. If the surviving spouse had previously made lifetime gifts to the deceased Settlor, this may affect the ability to make a deduction from the surviving spouse's taxable estate on his/her subsequent death.

Part 4 - Administrative provisions

The Trustees also have wide administrative powers to deal with the Bond and to reinvest the proceeds in any way they wish. They also have power to borrow funds, to make payments to parents or guardians of minor Beneficiaries and to delegate certain powers.

Part 5 - Appointment, dismissal, retirement and remuneration of Trustees

The trust contains comprehensive provisions applying to the Trustees.

The power to appoint new or additional Trustees is vested in the Appointor. The Settlor also has power to dismiss any Trustee provided at least one Trustee, other than the Settlor and a spouse of the Settlor, remains after such dismissal. There is no power to dismiss a Trustee after the death of



the Settlor and it must be remembered that Trustees under a trust subject to English law must act unanimously.

There are also powers to deal with the retirement of Trustees and corporate trustees.

Professional trustees are permitted by the trust deed to charge normal professional fees. The Trustees are permitted to take part in transactions and Trustees' decisions in which they have a personal interest.

Part 6 - Further trust provisions

These deal with the Trustees' duty of care and liability for loss to the trust fund.

The statutory duty of care contained in section 1 Trustee Act 2000 has been extended to apply to all functions of the Trustees. This statutory duty of care is a duty to act with such care and skill as is reasonable in the circumstances having regard in particular to any special knowledge or experience that the Trustee has or holds himself out as having and, in the case of a Trustee acting in a professional capacity (eg. a solicitor, accountant, stockbroker or independent financial adviser), to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

The liability of individual Trustees is limited so that they will not, generally, be held liable for any loss to the trust fund provided they act in good faith.

Trustees who are paid for their services are also liable for negligence.

Part 7 - Proper law

The Discretionary Gift Trust is governed by the law of England and Wales. However, it can also be used in Scotland or Northern Ireland as there is nothing in the laws of those countries which would preclude its use. In particular, the objectives of the Discretionary Gift Trust as indicated above, including the freedom from inheritance tax, will be achieved in all parts of the UK.

5. THE UK TAX IMPLICATIONS OF THE LONDON & COLONIAL DISCRETIONARY GIFT TRUST

In what follows it is assumed that the Settlor, the Beneficiaries and the Trustees of the trust are UK resident and UK domiciled. Special rules apply when this is not the case.

(i) ESTABLISHMENT OF THE TRUST

- For IHT purposes a transfer of value (a gift) takes place at the time the trust is created and when further amounts are added to the trust.
- Where there are two Settlers, each is treated as making a gift in proportion to the amounts actually transferred by each of them.



- When the trust is set up with cash (cheque) the amount of the gift will be obvious.
- When an existing Bond is made subject to trust, the value of the gift will be the value of the Bond (or the initial premium paid if greater less any part surrenders less an allowance for any decrease in the value of units since allocation at inception of the Bond).
- If the amount of the gift exceeds the available annual exemption(s), currently £3,000 for each Settlor (£6,000 maximum for each Settlor if the exemption for the previous tax year has not been used), it will be a CLT. This means that a potential liability at 20% may immediately arise if the value of the gift (less any annual exemption(s)) plus the value of all other chargeable lifetime transfers made by the Settlor in the previous 7 years exceeds the nil rate band. The 20% IHT charge applies to the excess over the nil rate band. If the Settlor is to pay the IHT, this will mean that the gift needs to be “grossed up” so that the actual amount of the loss to the estate on which tax is payable takes account of the tax payment.

EXAMPLE

Alan invests £327,000 in a London & Colonial Bond subject to a Discretionary Gift Trust. He has made no chargeable lifetime transfers in the previous 7 years and his annual exemptions have been used elsewhere. Either the Trustees can pay IHT of £3,000 [ie. 20% of (£327,000 - £312,000)] or Alan can pay IHT of £3,750 [ie. 20% of (£330,750 - £312,000)].

A further tax liability (at 20%) on the gift could arise if the Settlor dies within 7 years of making the gift although taper relief will be available to reduce the tax payable if the Settlor survives the gift by at least 3 years.

On the Settlor's death within 7 years of making the gift the full value of the gift when made will also be taken into account in determining the inheritance tax liability on the Settlor's estate.

Where a person makes a gift that is a CLT he may need to report it to HM Revenue and Customs on Forms 100 and 100a.

Whether a gift will need to be reported depends on the amount of the gift and the nature of the assets gifted. The gift will need to be reported in the following circumstances:-

- (1) Where the gift is of cash, it causes the donor to exceed the then nil rate band taking account of CLTs made in the previous 7 years.
- (2) Where the gift is of an existing Bond, it either causes the donor to exceed 80% of the then nil rate band taking account of CLTs made in the previous 7 years or the amount gifted exceeds the then nil rate band less CLTs made in the previous 7 years.

If the gift is of an existing Bond, form D34 will also need to be completed.



(ii) ADDITIONAL INVESTMENT

If any additional investments are made by the Settlor by adding to the trust fund, and these are not covered by the annual exemption(s), the amount invested will be treated as a further chargeable lifetime transfer with the IHT implications explained above. Additional investments into the trust can also have an impact on the periodic and exit charges (see below).

(iii) IHT WHILST THE TRUST IS IN EXISTENCE

As this is a discretionary trust, this means that special IHT charging rules apply. Under these rules there may be IHT charges

- on every ten-year anniversary of the trust - “the Periodic Charge” or
- whenever property leaves the trust (e.g. when capital is advanced to a Beneficiary or an absolute appointment of benefits is made) - “the Exit Charge”

THE PERIODIC CHARGE

Periodic charges at ten-yearly intervals may be applied to the value of the assets in the trust. The rate of inheritance tax charged will be determined on the basis of an assumed transfer by an assumed transferor. This will mean that it will broadly be necessary to take account of :

- the value of the property in the trust on the ten-year anniversary, certain additions made to the trust and the value, when they were set up, of any other trusts created on the same day (the assumed transfer)
- the Settlor’s cumulative total of transfers made in the seven years immediately preceding the creation of the trust (assuming there has been no added property) and any sums paid out of the trust in the 10 years prior to the anniversary (the cumulative total of the assumed transferor)

From the tax calculated based on these assumptions, an effective lifetime rate of tax will be established with a maximum of 20%. 30% of this effective rate will be the rate applied to the value of the trust property. The maximum liability will thus be 6% (30% of 20%) of the value of the trust property over the available nil rate band but frequently it will be much less or nil. Each case will, of course, depend on its own facts.

In cases where the Settlor has not made any chargeable transfers in the 7 years before he creates the trust, no payments have been made out of the trust in the last 10 years and there has been no added property, there will be no liability provided the value of the trust property at the time of the periodic charge does not exceed the nil rate band applicable at the ten-year anniversary. Any excess over the then nil rate band will suffer IHT at an effective rate of 6%.

EXAMPLE

Alan creates a Discretionary Gift Trust in October 2008 by investing £300,000 in a London & Colonial Bond. He has made no chargeable transfers in the previous 7 years. No payments are



made out of the trust in the first 10 years. In October 2018 the trust fund (ie. the Bond) is worth £450,000 and the nil rate band is £400,000. The IHT charge will be calculated as £50,000 @ 6% = £3,000. This equates to 0.66% of the total value of the fund.

If all of the trust fund is distributed before the tenth anniversary, in many cases no tax charge will arise (see next section). If assets remain in the trust after a distribution, or if further assets are added to the trust, the Trustees will need to seek specialist tax advice.

THE EXIT CHARGE

Exit charges will be based on the value of property leaving the trust or being absolutely appointed to a Beneficiary.

Exit charges within the first 10 years will be nil if the value of the initial chargeable lifetime transfer into the trust, before applying any IHT exemptions or reliefs (including the cumulative total of the Settlor's chargeable transfers in the 7 years prior to creating the trust and the value of any added property), is below the available nil rate band at the time of the exit. This means that if the available nil rate band when the trust is created is not exceeded it is very unlikely that there will be an exit charge. If an exit charge does arise, it will increase according to the number of quarter years that have expired since the trust was created.

The amount of any exit charge occurring after the first 10 years will depend on the rate of tax charged at the last ten-year anniversary (if any) and the length of time (in quarter years) that the property has been in the trust since the last periodic charge. If there was no charge at the previous ten-year anniversary there will be no exit charge.

EXAMPLE

In October 2024, 6 years since the first ten-year anniversary (when a 0.66% IHT rate was charged), the Trustees of Alan's trust make a part encashment of the Bond and pay £50,000 to a Beneficiary. The IHT charge will be $£50,000 \times 0.66\% \times 24/40 = £198$.

No IHT charge will arise on property paid out of the trust if there was no IHT charge at the last ten-year anniversary.

Exit charges should not arise on loans made by the trustees to Beneficiaries.

The occasion of a periodic charge and transactions that can give rise to an exit charge, such as capital payments to the Beneficiaries, may also need to be reported to HM Revenue & Customs on forms 100c and 100d (and form D34 where a Bond is involved) if they exceed a certain amount.

If there are joint Settlers who have contributed equally, the trust is effectively treated as two separate trusts, each settled by one Settlor, for all IHT purposes. IHT calculations are then applied to each of the trusts. Provided each Settlor originally contributed equally to the trust, the trust fund would effectively be divided into two for the purposes of calculating the ten-year periodic charge and any exit charge.



(iv) PAYMENT OF BENEFITS

Any payment of trust capital to the Beneficiaries (where the Bond is and always has been the sole asset of the trust) should not give rise to any income tax or capital gains tax liability. The IHT implications on payments would be as explained for exit charges in (iii) above. Chargeable event gains on encashment of the Bond to fund such payments are dealt with in (vi) below. It is, however, recommended that any such payments should not be made on a regular basis nor should they be of regular amounts so as to avoid any (albeit remote) possibility of an argument that the payments of capital have acquired the character of income with potentially unwanted income tax consequences.

(v) DEATH OF THE SETTLOR

- On the death of the Settlor (or, where relevant, either of the Settlers) more than 7 years after the creation of the trust, the value of the Bond will be outside of the Settlor's estate for IHT purposes.
- If the Settlor dies within seven years of establishing the trust, any liability to IHT on the chargeable transfer made when the trust was set up will need to be recalculated at death rates. If the gift was within the Settlor's available nil rate band there will be no IHT payable on the gift itself, but the nil rate band available to the estate of the Settlor will be correspondingly reduced. If the gift caused the nil rate band to be exceeded, so that IHT was paid at that time, IHT taper relief may be available if death occurs more than three years after the establishment of the trust.
- The value of the Bond will be available to the Trustees. If the Bond is encashed the IHT implications of the payment of benefits to Beneficiaries are as explained in (iii) and (iv) above.

(vi) CHARGEABLE EVENT GAINS MADE UNDER THE BOND

Any chargeable event gains arising from an encashment or a part surrender of the Bond held in trust will, during the Settlor's lifetime and in the tax year of the Settlor's death, be assessed to tax on the Settlor provided he or she is UK resident. This is so notwithstanding the fact that the Settlor cannot benefit under the Discretionary Gift Trust. However, where the Settlor does incur a tax liability following a chargeable event, he can recover the tax from the Trustees and this will not give rise to a reservation of benefit for IHT purposes.

In any tax year following that in which the Settlor's death occurs (or if the chargeable event gain arises while the Settlor is non-UK resident) any chargeable event gains will be assessed on UK resident Trustees at the special rate of 40%. There is no 20% tax credit for an offshore bond so the Trustees would pay the full 40% rate. To the extent that chargeable event gains fall within the £1,000 standard rate tax band, (which would be available to the Trustees following the Settlor's death), there will be a 20% charge.

If the Settlor is dead and the Trustees are not UK resident there are special provisions for charging tax on UK ordinarily resident Beneficiaries when they receive benefits from the



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trust. The method of calculating gains and the tax assessment is different and so in such circumstances professional advice must be sought by the Trustees and/or the Beneficiaries.

In all other respects the taxation of the Bond is the same as that for any other Bond held directly by an investor - for full details see the appropriate Bond literature. In particular, the Trustees can also take partial withdrawals within the cumulative 5% annual allowances without incurring an immediate tax charge.

(vii) CAPITAL GAINS TAX

No capital gains tax should arise in relation to any dealings with a Bond held subject to the Discretionary Gift Trust.

This Guide is based on London & Colonial's understanding of UK law and HMRC practice as at 1 November 2008. While every care has been taken, neither London & Colonial nor any of its representatives, officials or employees can accept any responsibility for any loss occasioned as a result of the information contained in this Guide in any circumstances whatsoever. Potential investors are strongly recommended to take independent professional advice before creating the trust.