Explanatory Notes

Discretionary Trusts

Drawn by:
Redchip Lawyers
redchip.com.au
redchip@redchip.com.au
P 07 3223 6100

Solicitors for:
Acis
acis.net.au
acis@acis.net.au
P 1800 773 477

Explanatory Notes
Discretionary Trusts

General Outline

Discretionary trusts can be confusing and complex, especially if you are using them for the first time. To assist your understanding, we have prepared these notes on the nature and operation of your discretionary trust. If you are uncertain of the nature of any of the Trustee's powers or whether a particular transaction may be lawful, you should immediately obtain professional advice as decisions made or discretions exercised by the Trustee may have significant tax and other consequences.

In any event, we recommend that you read the contents of the Trust Deed carefully and discuss it with your adviser.

A trust is an equitable obligation binding the Trustee to deal with trust property over which he has control for the benefit of named beneficiaries or classes of beneficiaries.

The key feature of a trust is that it creates an obligation. This obligation relates to the Trust Property and requires the Trustee to exercise control over the Trust Property for the benefit of the Beneficiaries.

A discretionary trust empowers the Trustee to determine the distribution of income and capital of the Trust. This discretion usually relates to whether income or a certain type of income will or may be distributed and to whom it will or may be distributed.

Discretionary Trust

The discretionary Trust Deed has the following features:

- It is established by a Settlor (i.e. the person or entity who formally settles or creates the Trust) by the payment of a nominal sum to the Trustee which constitutes the initial Trust Property. Stamp duty may be payable in some jurisdictions on the creation of a trust and may be calculated by reference to the amount settled or at a flat rate.
- The Trustee should (preferably) be a limited liability company established for this purpose. The Trustee has:

  (i) a discretion to allocate income or capital to all or any of the Beneficiaries, or to accumulate the income; and

  (ii) the powers of a natural person in relation to the Trust Property.

- The Beneficiaries may receive capital or income and consist of several defined classes of persons. These typically include parents, children and grandchildren, spouses of children and grandchildren and more generally, any company or trust in which any of the beneficiaries have a beneficial interest and any religious or charitable institution. The Beneficiaries are categorised into 3 classes (Primary, Secondary and Tertiary).
- For legal reasons, the Trust must terminate. This happens on the Vesting Day. The Trust may also be wound up at an earlier date. There is a formal legal process that must be undertaken to do so.
- The Trust Property may be classified as either "income" or "capital" and may be split into a variety of categories so as to most effectively minimise each of the Trustee's and Beneficiaries' tax liability.

The Settlor

The Settlor should be an independent person or entity who **must not** be:

- a Beneficiary;
- the Trustee; or
- the Appointor or Alternate Appointor.

The Settlor contributes a nominal sum to establish the Trust (say, $10.00). The payment of the settlement sum should be recorded in the books of the Trust, and be the first amount deposited into any new bank account established for the Trust. This amount must never be repaid to the Settlor.

The Trustee

The Trustee may be one or more individuals or companies. The benefit of using a corporate Trustee is that the liability of each shareholder is limited to the value of their own shares. The shareholders of the company may also be Beneficiaries of the Trust.

Note, however, that the Trustee is liable for any debts or liabilities incurred in the course of carrying on the Trust. The Trustee has a right of indemnity from the Trust Property to recoup those liabilities.

The Trustee may be removed and/or replaced by the Appointor or may resign by notice to the Appointor. If you wish to replace the Trustee, a deed of appointment and retirement of the Trustee is required. We recommend that you contact us in those circumstances as this must be done in accordance with the terms of the Trust Deed. Failure to ensure that amendments such as this one are properly carried out may have significant adverse consequences.

> The powers and discretions conferred upon the Trustee are extensive. We recommend that you read these powers carefully. If you do not understand any of them, please seek professional advice.

The Beneficiaries

Careful consideration should be made as to who you wish to be placed in each of the classes of beneficiaries.

We recommend that you obtain professional advice regarding the identity of the various classes of beneficiaries as this may have important tax considerations.

Normally, the Primary Beneficiaries are those persons who you wish to specifically name as Beneficiaries. The Secondary Beneficiaries include their spouses, parents, nephews, nieces, children and grandchildren. Tertiary Beneficiaries include such things as related companies and trusts etc.

The Trust Deed:

- allows the Trustee to nominate persons not named in the Trust Deed as additional Beneficiaries. (**Before exercising this power**, the Trustee should seek legal and taxation advice particularly regarding the stamp duty and tax (particularly Capital Gains Tax) implications of that decision - see the warning below);

- provides that the Default Beneficiaries are deemed to have received a distribution of Income in default of a determination or allocation by the Trustee in any year and where there are no nominated Default Beneficiaries, the undistributed Income is accumulated;
- provides for the distribution of the capital of the Trust to a certain class of Beneficiary if the Trustee does not make an allocation of all the capital of the Trust before the Trust terminates. Among other things, this prevents the Trust Property passing to the Settlor should the discretion not be exercised.

Whilst it is possible under the Trust Deed to add or delete Beneficiaries, before doing so, it is important to keep in mind that this **may result in stamp duty and Capital Gains Tax liabilities.** Please do not attempt this without seeking professional advice as adding and deleting Beneficiaries may constitute the transfer of a "trust interest". This may result in a stamp duty liability assessed at full conveyance rates on the full unencumbered value of all or part of the Trust Property at the time or substantial capital gains tax liabilities.

The Appointor

The Appointor is the person or entity who effectively controls the Trust. The Appointor has the power to appoint and remove the Trustee and, therefore, indirectly controls who makes decisions concerning the Trust. The Trust Deed gives the Appointor the power to remove the Trustee and appoint a new Trustee. If the Appointor dies, this power may be exercised by the Appointor's personal representatives.

If the Appointor dies, becomes mentally ill, bankrupt or if the Appointor is a company and has a receiver appointed, is wound up or is placed into liquidation, the Appointor is automatically removed. The Trust Deed allows an Alternative Appointor to be named who would in those circumstances, take over as the Appointor. If for some reason there is no Appointor or Alternative Appointor, the Trustee or Beneficiaries have the power to appoint a new Appointor.

Income Splitting

It is generally desirable to provide for the greatest possible number of potential Beneficiaries. The Trustee may then distribute the income of the Trust most effectively to take into account the relative income levels (and tax rates) of each of the Beneficiaries or classes of Beneficiary.

Distributions of Trust income to Beneficiaries with lower levels of income may take advantage of lower marginal income tax rates and, in some cases, the tax free threshold.

Corporate Beneficiary

It is also possible to nominate a corporate Beneficiary, taking advantage of the current lower rates of company tax. The use of a corporate Beneficiary is only generally beneficial where the company tax rate is lower than an individual's marginal rate of tax. A cash flow advantage may also result from distributions to a company, as the timing of collection of estimated tax in advance of final assessment is significantly later for companies than the tax instalment system for individuals.

Distribution of Income

The Trust income may be paid to an adult beneficiary or allocated or credited to the Beneficiary as required (but in either event, the Beneficiary would be considered to be "presently entitled" for tax purposes). In the case of a child Beneficiary, the income or a part of it may be appropriated, credited or paid to the child or for his or her benefit.

Distribution to Minors

Particular care must be taken when distributing Trust Income to Beneficiaries under the age of eighteen (18) years. We recommend that you seek professional advice regarding the tax rates imposed on minors.

Income Attribution

With the increasing complexities of the Income Tax Assessment Acts, it is important to provide for income attribution. The Trust Deed includes income attribution provisions.

Generally speaking, this means that the Trust Deed provides that the income of the Trust retains its character as income when it is distributed to the Beneficiaries.

The Trust Deed provides that the various types of income specified in the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997* may be distributed separately from the balance of the income of the Trust. These income streaming provisions are important in relation to interest income, dividend income and capital gains, and provide enhanced flexibility when using a discretionary trust.

Default Distribution

Under the current taxation system, any trust income not distributed to Beneficiaries in the tax year it is earned is taxed at highest personal income tax rate. It is therefore, necessary to provide for a default mechanism whereby any income left over as at 30 June of any given year would automatically be distributed to one or all of the beneficiaries.

Dividends

With the introduction of dividend imputation, it is important to ensure that franked dividends are distributed to individuals who are best able to use any franking credits available. The Trust Deed allows the passing through of franked dividends to the Beneficiaries most able to take advantage of them in the most flexible fashion.

Present Entitlement

Beneficiaries of discretionary trusts are taxed on the share of the Trust income only to which they are presently entitled.

Personal Services Income

In using a discretionary trust to carry on a business, it is important that the income of that business is not derived solely from the personal exertion of one individual.

Should this be the case, the Commissioner of Taxation may not accept that the income correctly belongs to the Trust, and may seek to assess the individual personally, negating any benefit in using a Trust.

Superannuation

A trust creates, through the Trustee, an employer/employee relationship in the case of a trading concern. You should seek professional advice about the tax-deductible benefits of superannuation for employees (including working directors) based on employer contributions, as opposed to individual superannuation contributions.

Asset Protection and Limited Liability

While a discretionary trust is not a separate legal entity, it does hold a favourable legal position.

Assets held by the Trustee are held for the benefit of all the potential Beneficiaries. The Beneficiaries are incapable of charging the assets of the Trust with their own debt.

The Trustee should not incur debts and/or to secure those debts against the assets of the Trust except where the debts are incurred for the benefit of or for the purposes of the Trust. Used correctly, assets can be isolated from the liabilities of the Beneficiaries and in many cases, the liabilities of the Trustee.

The use of a limited liability company as Trustee enhances asset protection by limiting the liability of the Trustee to the assets of the company for the debts incurred in the company's own capacity.

Distributions of Capital

The Trust Deed permits the Trustee to distribute the whole or a part of the capital to one or more Beneficiaries on or before the Vesting Day. If all the capital is not distributed before the Trust terminates, the Trust Deed provides that it will be distributed to the Beneficiaries. Capital Distributions are subject to "the profits first rule", pursuant to which profits (income realised or unrealised) are to be taken to have been distributed prior to untaxed amounts and contributed capital. Therefore, any distribution of "capital", will have to be carefully considered and we suggest you obtain taxation advice before doing so.

Capital Gains

In relation to the distribution of capital gains from a discretionary trust, it is important to consider whether the potential beneficiaries have capital losses which may be offset against capital gains, and also to consider the most tax effective distribution of the capital gain given the provisions of the *Income Tax Assessment Act 1997*. Again, you should seek professional advice in relation to those issues.

Losses Incurred by the Trust

Losses (whether of an income or capital nature) incurred by the Trust cannot be transferred or distributed to any of the Beneficiaries. They are "quarantined" in the Trust and may be carried forward and offset against future gains. If the Trust terminates before the losses can be offset, they are lost.

This differs significantly from a partnership, where the losses incurred by the partnership are distributed to each of the individual partners to be included in their personal income tax returns and offset against other assessable income.

Records and Accounts

A trust is not a taxable entity even though the Trustee must file a Return of Trust Income each year. In certain circumstances, the Trustee may be assessed and be required to pay tax on the whole or part of the Trust Income.

All decisions of the Trustee should be recorded in minutes and the transactions recorded in the books of account of the Trust. The Trustee owes a duty to account to the Beneficiaries.

> The Trustee must ensure that it does not mix it's own monies or monies not associated with the Trust with trust funds whether in the trust’s books or in the trust’s bank accounts.

If the Trustee is a company, we recommend that the Trustee company's sole activity be to act as Trustee for the Trust. However, if the Trustee carries on more than one function, the distinction between the Trustee acting in its capacity as trustee and acting on its own behalf must always be maintained. Separate books of account should be kept for the Trust and the company and its bank accounts should indicate the capacity in which the Trustee is acting, eg. The trust's bank account should be styled "X Pty Ltd as trustee for the X Discretionary Trust".

It is not necessary for the Trust's accounts to be audited. When using a corporate Trustee, its annual accounts and reports will reveal this fact and show the Trust's assets and liabilities. The Trust's accounts should indicate whether or not the assets of the Trust are sufficient to meet the liabilities which the Trustee has incurred in that capacity.

Stamp Duty

Stamp duty may be assessed if there is a transfer of a "trust interest," or a "re-settlement" of the Trust Property. A "re-settlement" or a transfer of a "trust interest" may occur in several circumstances, including if the Trustee varies the Trust Deed by adding or removing Beneficiaries. As this can have a significant financial impact, always seek professional assistance before making that decision.

If a Trust asset is transferred to a Beneficiary, the transfer may attract conveyance duty on the full unencumbered value of the asset transferred. In some cases, concessional rates of duty may apply. Legal advice should be sought in relation to those transactions before signing any documents of this nature.

Important Note

This publication is intended to convey general information only in relation to its subject matter. It is not intended nor should it be treated as legal advice by the reader. Any specific questions or issues should be directed to your accountant or qualified legal practitioner.

We do not provide legal, accounting, taxation, superannuation or investment advice or advice regarding stamp duty or other state or territory taxes nor in respect of any other matter.

Please note that superannuation laws and practice, taxation laws and practice, trust laws and stamp duty laws are continually changing and that significant fees, taxes, duties and penalties can be imposed when entering into arrangements of this type.

You must satisfy yourself that all documents comply with the relevant legislation and the law regarding arrangements of this type.
Advice should be obtained from qualified and licensed professionals before signing any documents.

We disclaim all liability for anything done or omitted to be done in respect of any documents supplied or arrangements entered into by you or your clients.