

Major Reasons for a Fully Discretionary Family Trust in Australia

Creditor asset protection for "risk" beneficiaries, eg trading company directors and professionals (the trust's role may be as a home equity trust). # Flexibility – each year the trustee can decide which beneficiaries are to benefit (the trustee's choice will be more limited if a family trust election is made). # Accumulation of trust income – while taxed at 46.5% in the trust, the rate is only 30% for as long as the trust income is "parked" with a corporate beneficiary. # Protection of assets from the primary beneficiaries' hostile family members. # Charitable or religious giving.

Trustee/Control

The trustee is either a company (for limited liability and administrative reasons) or one or more individuals such as the primary beneficiary or beneficiaries. The appointor (usually one or more of the primary beneficiaries) has considerable control via the power to appoint the trustee. Special provisions may need to be included or added in case of disputes between two or more future appointors of the trustee.

Trust Income and Capital

Generally, beneficiaries (rather than the trustee) are taxed on the income of the trust, based on any specific entitlements they may be given (eg to net capital gains or franked dividend income) or by the proportion of income they are allocated. The beneficiaries receive credit for any income tax already paid, eg via dividend franking credits. Any trust income that is accumulated by the trustee is taxed at 46.5%. Capital profits (usually subject to a 50% discount) are taxed both when trust assets are disposed to 3rd parties and on winding up of the trust. Loans to the trust may be interest free or interest bearing.

Trust income and assets can be counted for Centrelink means testing purposes for both trustees and non-excluded beneficiaries of the trust.

Control of a Family Trust

Shared between **trustee(s)** & **appointor(s)**

- ▶ Trustee administers the trust & has the power to make discretionary distributions to any one or more of the beneficiaries
- ▶ Appointor can replace the trustee – preferable to avoid having 2 or more appointors who are siblings

Trustee & appointor can be the same person

Key Features of an Australian Family Trust Deed (1)

Settlor

The settlor of a family trust is the person (permanently excluded from being a beneficiary of the trust and thus often a family friend of the primary beneficiary) who pays the (usually very nominal, eg \$10) settled sum to the trustee of a trust. Duty is payable in some Australian states and territories, eg NSW and Victoria, on trusts established by the payment of a settled sum.

Trustee

The company or one or more individuals that administer a trust and, subject to the terms of the governing trust Deed, makes decisions as to the investment of the trust fund and determines the distribution of both the trust income (usually by an annual resolution made by 30 June each year) and the trust capital.

Appointor

The appointor (usually one or more individuals and often also the primary beneficiary or beneficiaries and the trustee or trustees or the shareholder or shareholders in the company that is the trustee) has a crucial role to play in a discretionary trust as the appointor is the person (or persons) who holds the power to appoint and remove the trustee.

Gifts, Loans and Unpaid Allocations

The trust Deed needs to anticipate that the trustee will (in addition to the usually very nominal settled sum) receive either gifts or loans (or both) from persons associated with trust, eg the primary beneficiaries. Choosing whether to gift or to lend funds to the trust can have significant asset protection and estate planning implications for the persons associated with the trust. The trust Deed will also set out the responsibilities of the trustee in relation to the unpaid allocations of trust income or capital held on behalf of particular beneficiaries.

Beneficiaries of a Family Trust

Varies between Deeds, but usually include

- ▶ One or more primary beneficiaries
- ▶ Relatives of the primary beneficiaries
- ▶ Domestic partners of the above individuals
- ▶ Employees & contractors of the trustee
- ▶ Related entities, eg companies/secondary trusts
- ▶ Charitable organisations

Particular people may be nominated or excluded

Key Features of an Australian Family Trust Deed (2)

Class of Beneficiaries

The potential individual, company, secondary trust and charitable beneficiaries of a trust that gives the trustee discretion as to the distribution of the trust income and trust capital are defined by description in the trust Deed. The non-charitable beneficiaries of the trust are usually defined by relationship to the primary beneficiary/beneficiaries. The definition of beneficiaries is modified for special types of family trusts, eg capital reserved, descendants only, farm transfer and sole purpose insurance bond trusts.

Distribution of Trust Income and Capital

Providing the trust Deed permits it, the trustee is able to distribute uncategorised trust income and capital to one or more of the trust beneficiaries. Alternatively, should the trust income for income tax purposes include franked dividends or net taxable capital gains, the trustee can be given the power to separate the franked dividends (and the accompanying franking credits) or the net taxable capital gains from other trust income and distribute either or both category in different proportions to other trust income. Beneficiaries are taxed in the year income is allocated to them, rather than on eventual payment.

Default (or Specified) Beneficiaries

Such of the beneficiaries who, on a winding up of the trust, are allocated such of the trust capital and unallocated income of a discretionary or hybrid trust that has not been validly dealt with by a resolution of the trustee.

Trustee Powers and Vesting Date

The trust Deed has lengthy provisions setting out the extensive powers of the trustee. The maximum duration of most Australian trusts established or holding assets outside South Australia is 80 years.

Funding a New Family Trust

- ▶ Settled sum (usually nominal, eg \$10)
- ▶ Gifts, eg by primary beneficiaries wanting to reduce level of personally owned assets
- ▶ Interest free loans, eg by primary beneficiaries without asset protection concerns
- ▶ Interest bearing loans from beneficiaries or banks, particularly to fund investment or business assets

Funding a Family Trust – Both at Commencement and Ongoing

There are 7 main ways of funding a family trust, ie:

- payment of the (usually nominal) settled sum by the settlor to the trustee
- subsequent gifts by the primary beneficiary (or primary beneficiaries) and other parties to the trustee (some older family trusts exclude from further benefit any beneficiary who makes a gift to the trust)
- interest free loans by the primary beneficiary and other parties to the trustee
- interest bearing loans by banks and other financial institutions, private companies (these secured or unsecured loans often made pursuant to Division 7A of Part III of *ITAA 1936*) and by the primary beneficiary and other parties to the trustee
- accumulation of trust income (this occurs relatively rarely, because such accumulations are taxed at the highest marginal tax rate pursuant to s 99A of *ITAA 1936*)
- allocation of trust income to a private company owned by the trustee of the trust (Division 7A can become an issue where these allocations remain unpaid)
- appreciation of the assets held within the trust.

The choice between loans and gifts to fund a family trust can have a major impact on the statement of financial position or balance sheet of the trust: Both loans and gifts as a means of funding a family trust have advantages and disadvantages.

Loans to the trust, presuming they remain enforceable, while adding to the assets held on trust, will also be a liability of the trust and will reduce the extent to which the net worth of the trust is built up. The loans will form part of the personal estate of an individual lender (and thus able to be dealt with in the lender's Will) or the assets of a corporate lender. If the lender becomes bankrupt or insolvent, the loans will form part of the assets administered by the trustee in bankruptcy or liquidator.

Trust Income & Capital

3 definitions of trust income

- ▶ Accounting – same as trust law definition
- ▶ Tax – includes taxable capital gains
- ▶ Tax + discounted components, eg 50% discount

Income taxed as beneficiary's upon allocation, not on subsequent payment or application for benefit

Beneficiaries can be given “specific” entitlement to net capital gains & net franked company dividends & “present” entitlement to trust income generally

Taxation of Trust Income

Income of an Australian discretionary trust is generally taxed in the hands of a beneficiary when the income is allocated by the trustee to the one or more beneficiaries. (Payment or application for benefit of the income may take place months or years later.)

The trustee lodges an annual income tax return setting out which beneficiaries are entitled to receive the income of the trust each year. The entitlements to income each financial year will usually be determined by a trustee resolution in which the trustee chooses (from the class of potential beneficiaries) the particular income beneficiaries for that year, as well as any beneficiaries that are to receive trust capital.

Present Entitlement v Specific Entitlement

In making the distribution resolution, the trustee determines whether any of the beneficiaries are to be made specifically entitled to any net capital gains of the trust (the beneficiary must have a reasonable expectation of receiving the net capital gains) or to any franked dividends passing through the trust. The remaining income is determined by whoever has been given a vested and indefeasible interest in the trust income, ie a present entitlement.

The definition of trust income for present entitlement purposes is often at the discretion of the trustee and, if so, can usually be varied from year to year. If the definition chosen by the trustee or stipulated in the terms of trust is the trust law or accounting definition, the presently entitled beneficiaries are taxed on the trust income for income tax purposes in the same proportions as the trust law income they were allocated as presently entitled beneficiaries in that financial year. If the definition is the income tax definition (usually including any discounted components), the presently entitled beneficiaries will be taxed on the quantum of the trust income they were allocated as presently entitled beneficiaries.

Family Trust Elections

Tax election – effectively limiting distributions from a non fixed trust to a family group (*see next slide*)

May be needed to claim:

- # **Dividend franking credits** (post 1997 shares)
- # Income **losses** in the trust or in a company owned by the trust
- # **Bad debt** deductions

Consequences of a Family Trust Election

A family trust election is made for Australian income tax purposes to enable a trust (most commonly a family or other non fixed trust or life interest) to claim the benefits set out below:

- A beneficiary being able to claim **dividend franking credits** – this need for a family trust election only applies to shares acquired post 1997 (*not a consideration where the total franking credits a beneficiary receives from all sources do not exceed \$5,000.*)
- To overcome the difficulty in claiming **losses** in private **company/unit trust** owned by the trust.
- To overcome the difficulty in claiming **losses/bad debt deductions** in the trust itself.

Reasons for Deferring Elections

- **No immediate reason** to do so – family trust *elections are irrevocable for non-fixed trusts.*
- Possible **long term disadvantages**, *eg trust property might be distributed to, or even used, by a beneficiary or other person outside the family group.*

Reasons for Not Electing At All

The intended beneficiaries of the trust include beneficiaries (or non professional advisor trustees/appointors) who are not members of the same family group.

Note family trust elections may not be needed for deceased estates, life interests and testamentary trusts where the only reason for electing would have been because of the shares in listed and unlisted companies held by the executor, administrator or trustee.

Family Group (for Family Trust elections)

Test Individual + Current or Former Spouse + their:

Parents & Grandparents
 Descendants of Parents
 Brothers & Sisters
 Nieces & Nephews
 Current/Former Spouses of
 any of the above
 Associated Entities

Associated entities

Companies/trusts wholly owned
 by members of the family group
 Trusts with same test individual
 Companies/trusts with interposed
 entity election
 Charities exempt from Australian
 income tax

If there are no surviving members of a family group, trust capital can be paid without penalty to a deceased estate

Family Group v Class of Beneficiaries

The class of beneficiaries is defined by the trust Deed and may be wider, narrower or different in scope to the beneficiaries that fall within the family group for income tax or means tested pension purposes.

Notable exclusions from the Family Group

Aunts/uncles. # Cousins and their descendants. # Non-related financial dependants, eg a foster child.

Interposed entity elections

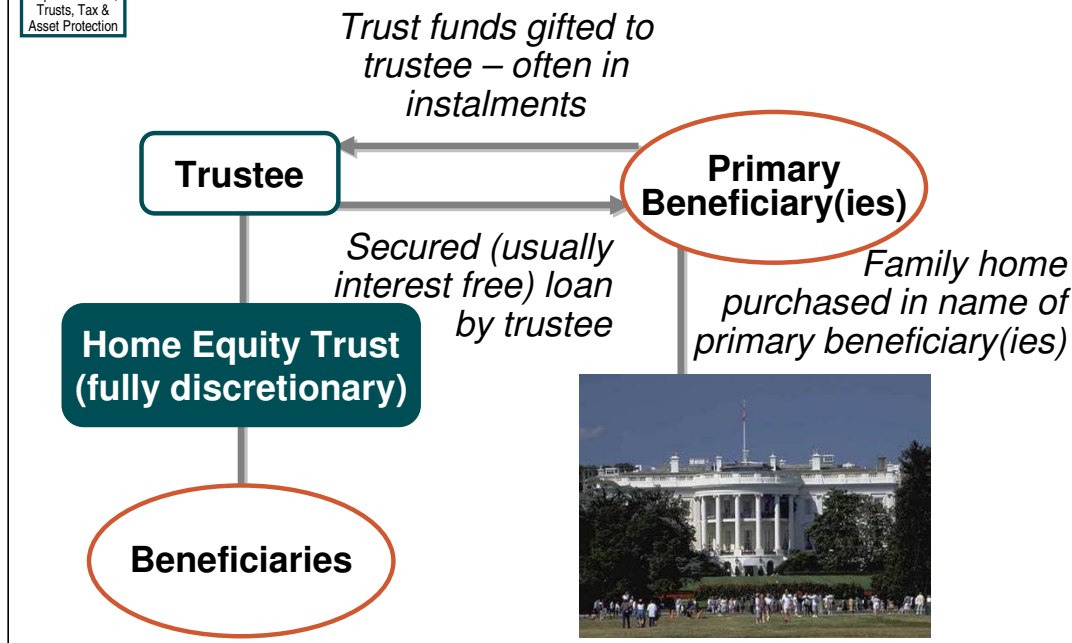
Companies and trustees of trusts may need to make an interposed entity election to fall within a particular family group. Such an election is not necessary for a company or trust where all the shareholders or beneficiaries are members of the family group. An interposed entity election is also not necessary where two trusts have the same test individual in their respective family trust elections.

Deceased Estates

A deceased estate is excluded from the family group unless:

- all deceased estate beneficiaries have both fixed entitlements and are members of the family group (note that most minors named as beneficiaries under a Will as a beneficiary of the deceased estate are required to attain an age such as 18 years before inheriting and as such have prospective and defeasible interests, rather than fixed or absolute entitlements)
- the deceased estate is a "family trust" for income tax purposes with the same test individual and the executor or administrator has made a family trust election
- all members of the family group (including family members who are not beneficiaries of the trust) have died.

Home Equity Trust



Major Reasons for a Home Equity Trust in Australia

Creditor asset protection for the home owner(s), eg because of their occupation risk; often the trust's sole role holding the equity in the family home. # Preservation of CGT & land tax main residence exemptions for family home (not possible if the home is owned in the family trust). # Protection of assets from the primary beneficiaries' hostile family members (the trust may be capital reserved).

Trustee/Control

The trustee is either a company (for limited liability and administrative reasons) or one or more individuals such as the primary beneficiary or beneficiaries. The appointor (usually one or more of the primary beneficiaries) has considerable control via the power to appoint the trustee.

Gift of Funds into the Trust

After payment of the settled sum, eg \$10, by the settlor of the trust, the trust is funded by a gift (or a series of gifts) by the primary beneficiary or beneficiaries). Gifts are funded by accumulated savings, sale proceeds of previous home or a series of smaller instalments, eg \$10,000 on day one, immediately lent back on the same day, \$10,000 on day two, immediately lent back, \$10,000 on day three, immediately lent back, etc. To be effective, delivery of the gift or gifts should actually occur, eg by money being transferred into the trustee's bank account and then lent back via the home owner's bank account. For bankruptcy purposes, the gifts must be made outside the bankruptcy clawback periods in the *Bankruptcy Act 1966*.

Security

To enable the trustee to be a priority creditor, the loan by the trustee will be secured by a 1st or 2nd mortgage. Interest free loans avoid the need for income tax returns.

Family Trust – Further Reading

**Australian Master Estate
Planning Guide –
Chapter 10 & (in the
Premium Edition) 46**

**You Can't Take It
With You –
Chapter 10**

The latest version of this Pocket Summary is at
www.mooreslegal.com.au/services/estateplanning/pocketsummaries

Further Reading

- *Australian Master Estate Planning Guide* – Allan Swan, to be published (in both a Standard and Premium Edition) by CCH in 2012.
- *Estate Planning Documents* – Allan Swan, Moores Legal (includes many of the Pocket Summary series).
- *You Can't Take It With You* – Andrew Simpson, Wrightbooks.
- *Tax Issues in Family Law Property Settlements* – Peter Szabo, Moores Legal.

Australia-wide Seminar, Workshop & other Presentations – Allan Swan

EPSTTAP Introductory: • Estate Planning – The A-Z (includes pages 5-8 of this Pocket Summary) • Superannuation – The A-Z • Trusts – The A-Z (all).

EPSTTAP Advanced: • Estate Planning – Case Studies • Estate Planning Masterclass (5-8) • Superannuation – Death Benefits & Binding Nominations • Testamentary Trusts – Drafting the 6 Major Types (5-7) • Trusts & Deceased Estates – Income & Capital Distributions (1, 3 & 5-7) • AMEPG Chapter Workshops.

Allan's local Moores Legal client, community & discussion group topics are:

- Estate Planning – Protecting & Enhancing Wealth • Estate Planning – Vulnerable Family Members • Family Trusts – Income & Capital Overview • Farm Succession – Avoiding Tax Pitfalls & Anticipating Disputes • Providing an Estate Planning Service for Clients • SMSFs – Instalment Warrants, Pensions & Binding Death Benefit Nominations • Tax & Business Structures Overview (1-5) • Update – Estate Planning, Superannuation, Trusts, Tax & Asset Protection.

To book Allan for any of these topics, contact Lilian Bruère on 03 9843 2153. All Pocket Summaries are copyright and are for general information purposes only and should not be relied on as (or in substitution for) legal or other professional advice.