# Advice Guide - Discretionary Trusts

## How to read this document

Managing your finances to meet your day to day requirements as well as your long-term goals can be a complex task. There are all sorts of issues you need to consider such as taxation, legislation, protecting your wealth and assets, associated costs and the inherent risks of investment. When undertaking a financial plan it is important that you understand how these issues will impact on you and what you should expect over time.

This document contains general information about the benefits, costs and risks associated with certain product classes and strategies. It is designed for use in conjunction with a Statement of Advice that takes into account the circumstances and objectives of an individual. Before making a commitment to purchase or sell a financial product, you should ensure that you have obtained an individual Statement of Advice prepared by WARR HUNT Pty Ltd.

As legislation may change, you should ensure you have the most recent version of this document.

Please contact your Adviser if you do not understand anything or need further information.

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# Overview of trusts

Trusts can be used to hold passive investments (e.g. shares, property and cash) or own and operate a business.

Furthermore, in the form of a testamentary trust, they can facilitate a tax-effective distribution of income and capital from an estate to beneficiaries as well as provide asset protection in certain situations.

There are two main types of Trusts; Non-discretionary and Discretionary.

- A non-discretionary trust will distribute income according to a set distribution strategy as set out in the trust deed. This type of trust often referred to as a Unit Trust.
- In a discretionary trust, the trustee has total discretion on how to allocate income and assets to the beneficiaries. In this instance, the trustee considers the financial position of each of the beneficiaries before determining how to allocate each year's distribution. This is the most common form of Trust.

Hybrid trusts are a combination of both of the above.

In this Advice Guide we outline the benefits of **discretionary trusts** and some key issues to consider when thinking of using them. Refer to the Appendix for definitions of a 'trust deed' and the 'parties involved in a trust arrangement'.

### What's a discretionary family trust?

A **discretionary trust** is created when an individual known as the 'settlor' gives the trustee money or property for the benefit of the beneficiaries. This 'settled sum' is the original trust fund.

A **discretionary family trust** is, in very simple terms, a family trust where the trustees have the discretion to distribute income and capital. To be treated as a family trust for tax purposes, the trustees have to complete a '**family trust election' (FTE)** and limit the beneficiaries to eligible family members.

Where the marginal tax rate of all beneficiaries is higher than the company tax rate of 30%, subject to the trust deed, the trust income can be allocated to a corporate beneficiary (including under an FTE).

This ensures no part of the income earned by the trust will be taxed, in the first instance, at a rate higher than the company tax rate.

Beneficiaries of a trust are generally required to submit a tax return, unless they are eligible for an exemption, and the trustees should provide details of the income distributions to beneficiaries to assist with their tax affairs. The trustees may have withholding tax obligations for certain beneficiaries such as minors and bankrupts.

## What’s a testamentary trust?

A testamentary trust is a trust established via a Will, where estate assets are owned and controlled by the trustees and not the beneficiaries in their own right.

A testamentary trust can be fully discretionary, which would allow the trustees to decide how the income and capital is distributed to beneficiaries.

Alternatively, a testamentary trust can be a fixed trust providing beneficiaries with a fixed entitlement to income or capital, or a combination of both.  Generally fixed trusts are not commonly used unless there is an intention to set up a ‘special purpose’ trust, like a superannuation proceeds trust or special disability trust.

A **testamentary trust** is established from instructions in a client’s Will.  It is important to have a solicitor correctly draft the Will to ensure the testamentary trust achieves your goals.

The trust can only be established with the net assets of a deceased estate after taxes and liabilities have been paid out by the executor.

In some cases, the Will may be drafted to give the executor the option of creating a testamentary trust rather than making it compulsory.

Consideration may be given to having more than one testamentary trust where there is more than one beneficiary.  This allows the executor and/or trustees to deal with the entitlements of beneficiaries in different ways.

Similarly, to be treated as a family trust for tax purposes, the executor and/or trustees of the testamentary trust have to complete a **‘family trust election’ (FTE)** assuming the beneficiaries are eligible family members.

## Family trust election (FTE)

The FTE must nominate a ‘test individual’ whose family group is to benefit from the trust and specify an income year from which it is to take place.  The family group can include;

- any parent, grandparent, brother, sister, nephew, niece or child of the test individual or the test individual’s spouse
- a range of other family members as defined in section 272-95 of ITAA 1936, and
- certain entities specified in section 272-90 of ITAA 1997, including those covered by an interposed entity election.

The Australian Tax Office releases a ‘Family trust election, revocation or variation’ form each year that can be used to make an FTE.

In addition to making an FTE, specific provisions need to be included in the trust deed that provide the trustees with their discretionary powers and ensure the beneficiaries do not have a fixed entitlement to income and capital from the trust.

In the absence of making the FTE, franking credits from earnings of the trust cannot pass to beneficiaries, other than those with total franking credits of less than $5,000, and tax losses may not be able to be carry forward in the trust.

Given the taxation and legal issues that need to be considered and addressed, it's important that you seek advice from your accountant and/or lawyer before establishing a discretionary family trust.

## What are their benefits?

Whether a discretionary trust is for the purpose of holding testamentary assets, passive investment or for operating a business, the benefits are as follows;

**Tax-effective income splitting**

A discretionary trust allows for the splitting of income generated by the trust's assets between the beneficiaries on a year by year basis.

By selecting beneficiaries on low marginal rates, the trustees can manage the taxation of income earned by the trust.

Because no beneficiary of a discretionary trust has a fixed entitlement to the trust assets, a CGT event would occur when a trust asset is disposed of by sale or transfer.

Capital gains made on disposal of trust assets can, however, be split between the beneficiaries who may be eligible to apply the 50% discount to the assessable gain, thus reducing the CGT payable.

Income and capital gains that are distributed from a testamentary trust directly or indirectly to beneficiaries under the age of 18 are subject to normal individual tax rates, not child tax rates.

**Note:** Any income to which no beneficiary is presently entitled will be taxed in the hands of the trustee at 49% (including 2% Medicare levy).

**Asset protection – relationship breakdown**

A discretionary trust allows the assets to remain within the family group.  For example, a future spouse of a child would not be a trust beneficiary.

In some circumstances Family Law allows the Court to look through trusts.  Factors such as whether one of the spouses controls a trust and the ability of a spouse to benefit from a trust may be relevant. The Court has the power under Part VIIIAA of the Family Law Act to make orders binding on third parties such as trustees.

**Asset protection – upon bankruptcy**

The assets in a discretionary trust will generally be protected from claims by creditors if a beneficiary becomes bankrupt.

A key exception is where there is unpaid present entitlements, which may arise when distributions are notionally made to (and taxed in the hands of) a beneficiary and the money is retained in the trust.

Income from a trust would not be protected, but the trustees have the option to not distribute income to beneficiaries who are (or have potential to become) bankrupt or limit distributions to such people.

**Control 'beyond the grave'**

A carefully drafted testamentary trust may determine that capital cannot be distributed to a beneficiary until they are a particular age (e.g. 21, 25 or older).

Alternatively, the rules may leave it to the trustees to determine when capital is payable. This discretion would enable the trustees to consider beneficiaries' circumstances before paying out the capital rather than relying on the beneficiary turning a particular age.

More broadly, a trust can be specifically tailored to ensure that the principal's assets stay within their family or their direct descendants for a period of up to 80 years.

The discretion of a trustee may also extend to special need beneficiaries, including those who are spendthrift or have a gambling, alcohol or drug addiction.

## Key issues to consider

**Trustee considerations**

When a discretionary trust is considered as a part of any estate planning strategy for clients, it is important they also consider who is nominated as the trustees of the testamentary trust. The trustees will be responsible for managing the assets of the trust until payable to the beneficiaries. The trustees need to understand what they client is hoping to achieve and details should be provided in the Will or deed of wishes.

**Unpaid present entitlements**

Discretionary trusts will often retain distributions that have been notionally allocated to (and taxed in the hands of) certain beneficiaries. This results in the creation of what's called a 'beneficiary loan account'.

These loan accounts belong to the beneficiaries who were entitled to, but did not receive the trust distribution and will form part of their estates when they die.

With testamentary trusts it may, however, be possible to include provisions in the beneficiary's Will that stipulate that the trust doesn't have to repay the loan if a beneficiary dies.

**Cost and ongoing advice**

As a discretionary trust is a legal structure, it will need to satisfy certain requirements, such as completing annual tax returns. The trustees may need to seek professional advice (e.g. legal, accounting or financial planning) and the costs paid by the trust should be compared to the benefits of maintaining the trust.

**Tax Considerations**

While discretionary trusts may provide a number of potential taxation benefits the tax law has been changed to address a number of uncertainties and longstanding problems with the taxation of trusts, some of which were highlighted by the High Court decision in Commissioner of Taxation v. Bamford (2010).

These changes were made through the Tax Laws Amendment (2011 Measures No. 5) Act 2011 which ensure, if permitted by the trust deed, the trust's capital gains and franked distributions can effectively be streamed to beneficiaries for tax purposes by making those beneficiaries specifically entitled to those amounts.

Capital gains and franked distributions to which no beneficiary is specifically entitled will be allocated proportionately to beneficiaries based on their present entitlement to income of the trust estate.

In addition, the anti–avoidance provisions in Part IVA of ITAA 1936 may apply in circumstances where the dominant purpose for setting up a trust arrangement or scheme is to derive a tax benefit.

## Who should consider them?

A discretionary trust could be suitable if you;

- Are concerned about protecting your assets from personal or business creditors
- Have (or will potentially have) substantial assets other than their principal place of residence and superannuation interests, and
- Want to arrange effective tax planning and asset protection for your beneficiaries.

In addition, where a client has a blended family or minor children there may be other circumstance where a testamentary trust is appropriate. However the benefits of having a testamentary trust as part of an estate planning strategy must be considered in consultation with legal advice.

# Appendix

## What is a trust deed

A trust deed is a legal document that sets out the purpose of holding assets in trust for beneficiaries. The deed will identify the trustees and beneficiaries, and their rights and obligations. It should also set out the governing rules of the trust and the way benefits are paid to beneficiaries.

The trust deed should give direction to the trustees depending on its purpose and appropriate legal and tax advice should be sort in drawing up the deed.

## Parties involved

**Settlor**

The first party to a trust deed is often a settlor who gifts an asset which may include money to establish the trust. The settlor cannot be a trustee and cannot be a beneficiary of the trust and therefore needs to be a third party who has no interest in the trust.

**Beneficiaries**

Beneficiaries are those who have an entitlement to income and/or capital distributions of the trust. In accordance with the trust deed beneficiaries can be made up of individuals, companies and other trusts.

It would be considered best practise that there are different classes of beneficiaries identified in the trust deed to ensure the survival of the trust.

**Appointor**

An appointor effectively controls a trust, and according to the trust deed can appoint and remove trustees of the trust.

While it is not mandatory requirement to have appointor identified in the trust deed it may be considered best practise to have one to deal with the death or insolvency of trustee(s).

**Trustees**

Trustees have legal but not beneficial ownership of trust assets and they have responsibility to manage the affairs of trust accordingly to the trust deed and best interest of all beneficiaries.

Trustees can either be one or more individual(s) or a company. Individual trustee(s) may not be below 18 years of age or a disqualified person(s).

If the trustee is a company, its affairs are controlled by its directors and eventually by its shareholders by virtue of their power to appoint or remove directors.