GUIDE TO FAMILY TRUSTS

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This memorandum helps explain the commercial advantages and disadvantages of conducting an investment or a business through a family trust. The various planning opportunities and pitfalls are considered and consideration is given to how trusts may be used to create and protect wealth.

The roles played by the various parties, ie the trustee, the beneficiaries, the appointor and the settlor are explained.

The trustee's duties are described, a resolution of directors is provided and the life cycle of a typical family trust is explored, including the procedure for ending the trust.

In summary, the income tax, capital gains tax and asset protection attached to trusts means that they are often the preferred method of structuring a business or investment activity. This is so even when the business or investment is only of modest size.

What is a Family Trust?

A family trust is a discretionary trust where the beneficiaries are all or predominantly members of the same family. To differing degrees the beneficiaries see themselves as a common economic unit and are happy for trust income to be distributed in a way that satisfies their common interests and objectives.

Frequently these common interests and objectives include minimizing the total tax paid on the trust's net income.

But this just raises the question "What is a 'discretionary trust'?" Indeed, what is a "trust"?

Trusts originated in England hundreds of years ago. Their original purpose was to avoid feudal dues payable on land transactions. A landowner would give a piece of land to a friend to "hold on trust" for his descendants thereafter. This arrangement avoided paying dues as the land passed from fathers to eldest sons, through the generations.

Modern trusts are far more evolved and sophisticated than these early primitive trusts. Although, strangely, they have not lost their original tax planning advantages.

A modern trust is a fiduciary relationship rather than a legal person. The relationship requires one person to legally own an asset for the benefit of another person or set of persons or, in some cases, a purpose (eg a charitable cause). The person who legally owns the asset is called the trustee, and the person or persons for whose benefit the asset is held is called a "beneficiary" or, collectively, and rather pompously but thankfully rarely, the "cestui que trust".

A trust is defined in Underhill's Law Relating to Trusts and Trustees as follows:

"A trust is an equitable obligation, binding on a person ("trustee") to deal with property over which he has control ("trust property") either for the benefit of persons ("beneficiaries") of whom he may be one, and any one of whom may enforce the obligation, or for the advancement of certain purposes."

Most Australian businesses are carried on in trusts. Trusts can be small, for example, a family trust may own a small unit with a cost of less than $80,000, or they can be very large: some of the managed investment trusts have more than 20,000 unit holders or beneficiaries. A trust can be very short lived, as is the case, for example, when a deposit for a house is left with an estate agent; or a trust can be very long lived, as is the case, for example, for most family trusts which may last for up to eighty years.

Most trusts are evidenced by a trust deed. This is a legal document prepared by a solicitor which sets out the purpose of the trust, the rights and obligations of the beneficiaries, the powers of the trustee, and the identity of the beneficiaries, the trustee and the appointor. A formal trust deed is not essential to create a trust. But it is highly recommended and in practice mandatory, for taxation purposes at least.

THE INCOME TAX, CAPITAL GAINS TAX AND ASSET PROTECTION ATTACHED TO TRUSTS MEANS THAT THEY ARE OFTEN THE PREFERRED METHOD OF STRUCTURING A BUSINESS OR INVESTMENT ACTIVITY.

Discretionary Trusts

The phrase "discretionary trust" deserves specific comment. Most family trusts are discretionary trusts. The word "discretionary" refers to the power or discretion the trustee has to decide which beneficiary or beneficiaries get the net income and the capital from the trust each year or on winding up the trust. These discretionary powers are the critical element in creating the income tax, capital gains tax, asset protection and social security advantages of a trust and these are discussed in detail below.

So, in summary, a family trust usually involves a trustee (typically a company) holding an asset on trust for the benefit of a group of family members known as "the beneficiaries". Family members usually own the trustee company's shares, and therefore it is they, through the trustee company, who decide how the trust's assets and income are dealt with. The trustee is appointed by a person called the "appointor". The appointor is usually nominated in the schedule to trust deed and is typically the person (or persons) who decides to set the trust up in the first place.

An important point to note is the nature of the duty owed by the trustee to the beneficiaries. It is one of the "utmost good faith" and it requires the trustee to act in the best interests of all of the beneficiaries at all times. This is the highest duty recognized by the law and requires the trustee to put the interests of the beneficiaries above those of the trustee at all times. The duty of utmost good faith stops the trustee from using the assets for its own purposes and not for the benefit of the beneficiaries. Trustee's duties are discussed in more detail below.

The Beneficiaries

The beneficiaries are the persons for whose benefit the trustee holds the trust property. In most trust deeds the "primary beneficiaries" will be specified, and will usually be the people setting up the trust, and perhaps their children or other close relatives. The "general beneficiaries" will be defined by reference to the primary beneficiaries.

For example, the class of persons who are general beneficiaries will usually be the parents, grandparents, brothers, sisters, children, grandchildren, aunties, uncles, nephews, and nieces of the primary beneficiaries. It is common for the definition to also include any private company or trust in which any natural person general beneficiary has an interest or expectancy.

Most of the advantages of family trusts stem from the trustee's discretion over which beneficiary receives net income distributions or capital distributions from the trust each year, or on the vesting of the trust. Because of this discretion the law does not recognize any property right in a beneficiary over the assets owned by the trust. This is because no single beneficiary owns the assets held in the trust. The trustee has legal ownership but not beneficial ownership of these assets, and is required to hold them for the benefit of the family members who are specified in the trust deed to be the beneficiaries of the trust.

As a group the beneficiaries own the assets, but no one beneficiary owns them, or part of them. This means it is usually not possible for a beneficiary to unilaterally do something that places the trust's assets at risk. Therefore, if the beneficiary becomes bankrupt there is usually nothing the trustee in bankruptcy can do to get his hands on the trust's assets (unless of course the trust has mortgaged the assets or guaranteed the performance of the beneficiary's debts, or otherwise involved itself in the bankrupt beneficiary's affairs.

Primary beneficiaries do not have any greater rights over the trust property than general beneficiaries. In fact, as indicated above, they do not have any rights at all: they only have an expectation that the trustee may exercise its discretion in their favour.

DISCRETIONARY POWERS ARE THE CRITICAL ELEMENT IN CREATING THE INCOME TAX, CAPITAL GAINS TAX, ASSET PROTECTION AND SOCIAL SECURITY ADVANTAGES OF A TRUST.

The Appointor

The role of the appointor deserves comment. The appointor is the person who decides who will be the trustee of the trust. The appointor controls the trust, since if the trustee did not follow the appointor's directions, the appointor would simply sack the trustee and appoint a more compliant trustee in its place.

The appointor is normally the person or persons who decided to set the trust up in the first place. The "initial appointor" is usually specified in the trust deed. The deed normally states that the initial appointor may resign as appointor and instead nominate in writing some other person(s) as appointor in his or her place. If an appointor dies without making such a nomination then the deceased appointor's legal personal representative will become the appointor of the trust, subject to the trust deed.

The Trustee

The trustee is normally a company owned by the client and set up specifically to act as trustee of the trust. The shareholders and directors control the trustee. The trustee legally owns the trust property but does not beneficially own the trust property. Beneficial ownership of the trust property lies with the beneficiaries.

The trustee can also be any competent natural person over the age of 18 who is not bankrupt or under some other legal disability.

The appointor, of course, is the person who really controls the trust. This is because the appointor can terminate the trustee's appointment and appoint an alternative person as trustee in its place. The role ofthe appointor is discussed in the preceding paragraphs.

The advantages of using a company as a trustee are that:

(i) having legal ownership of the trust's assets in the name of the company makes it very clear that they do not belong to the individuals, and this means they are less at risk, particularly if the individual is in a risky business or profession;

(ii) the company may stay in existence virtually forever, and will not die or become unable to manage its own affairs. This means things are simpler and there is less bother with changing trustees and re- registering ownership with authorities such as the various state Titles Offices;

(iii) the reach of the Family Law Court is reduced, in some circumstances;

(iv) the directors or other persons who control the company can exercise defacto control without being personally involved in the trust.

The disadvantages of using a company as trustee are largely the extra cost of setting up and running a company each year.

The Settlor

The settlor (or, sometimes, the grantor) is the person who the law treats as establishing the trust. This is really a legal fiction: the settlor is usually someone connected to the trustee and the beneficiaries such as a friend or an accountant who pays a nominal sum, say $10, to the trustee to formally establish the trust. Obviously the bulk of the trust's initial assets will be contributed later by the client and related persons, not the settlor.

Most modern trust deeds will contain a clause saying that the settlor is not able to benefit under the trust deed. This is because of a tax rule that may create a tax charge for the trust if such a clause is not included in the deed.

Sometimes clients are concerned that the name of a person such as their accountant appears in the trust deed, and query whether this creates rights in favour of that person. It does not. The role of the settlor is a mere formality once the trust starts and the settlor has no rights whatsoever in respect of the trust. Inserting the accountant's name in the deed as the settlor is a convenient convention and is a simple way of setting the trust up.

THE SETTLOR HAS NO RIGHTS WHATSOEVER IN RESPECT OF THE TRUST. INSERTING THE ACCOUNTANT'S NAME IN THE DEED AS THE SETTLOR IS A CONVENIENT CONVENTION AND IS A SIMPLE WAY OF SETTING THE TRUST UP.

Advantages of a Family Trust

The major advantages of a family trust are:

(i) income tax advantages;

(ii) capital gains tax advantages;

(iii) asset protection advantages; and

(iv) as retirement planning vehicles.

Each of these advantages are dealt with in turn in the following paragraphs.

Income Tax Advantages

A major advantage of a family trust is the ability of the trustee to select the person to whom the trust's net income will be distributed each year. Provided certain formalities are observed, which are discussed below, and subject to one qualification, which is also discussed below, trust net income may be distributed amongst the beneficiaries in a way which minimizes the total income tax payable on it.

For example, a family trust controlled by a doctor may have two beneficiaries who are over the age of eighteen and who have no other taxable income. The trust has net income of $10,000 attributable to administration services provided to the doctor's medical practice. The trustee may resolve to distribute $5,000 to each of the two beneficiaries and, if it does so, no income tax will be paid on the $10,000 so distributed. Had the doctor derived the $10,000 of income personally income tax of $4,800 would have been payable this year and Pay As You Go tax of about $5,200 would have been payable early in the following year (for offset against the following year's income tax).

The family trust has therefore saved the doctor $4,800 in tax each year forever. After ten years, at ten per cent interest, this accumulates to more than $100,000 in total cash savings. After twenty years this adds up to more than $300,000 in total cash savings.

Capital Gains Tax Advantages

Family trusts have capital gains tax advantages compared to companies. This is because the 50% discount factor on capital gains disposed of within a year applies to trusts but does not apply to companies.

Specific advice should be sought from your accountant before deciding to acquire a specific asset in the name of a trustee of a family trust.

Corporate Beneficiaries

Family trusts can be combined with private companies to get the benefit of the 30% tax rate currently applying to private companies. This is done by arranging for the trust to distribute net income to the trust each year. The main rule here is that the cash must be actually paid over to the corporate beneficiary, and then retained in the corporate beneficiary. If this does not happen there is a risk that special anti-avoidance rules applying to private company loans may apply.

Asset Protection

Another major advantage of a family trust is the ability to put valuable assets beyond the reach of potential creditors. We have seen family trusts save the day many times.

In most cases assets transferred to a family trust may not be able to be accessed by creditors if the transferor gets into financial difficulty or even goes bankrupt. This is because the transferor has no interest in the transferred property and has no interest in the family trust which is recognized at law.

For example, a doctor acquired a home worth $300,000 through a family trust and rented it back off the trustee. The doctor also acquired a share portfolio worth $200,000 as an inheritance from a grandparent: the doctor's family trust was the beneficiary under the grandparent's will. Some years later the doctor guaranteed a large business loan for his brother. The brother's business collapsed and the bank called up the guarantee. The bank could not touch the family home and the share portfolio. These assets simply did not belong to the doctor. They belonged to the trust. As a result the bank could not do anything to get its hands on these assets.

This asset protection can go on down through the generations. For example, if the doctor dies and leaves the share portfolio and the family home to a daughter, these assets will be a marriage asset should the daughter's husband one day divorce her.

ANOTHER MAJOR ADVANTAGE OF A FAMILY TRUST IS THE ABILITY TO PUT VALUABLE ASSETS BEYOND THE REACH OF POTENTIAL CREDITORS.

If these assets remain in the family trust they will normally not be marriage assets in a divorce situation. This means that the (ex) son-in-law gets nothing. The same thing happens if a son gets into business difficulties or investment difficulties and is sued by creditors.

If necessary, your family trust's deed can be amended to make it more restrictive and protective of the next generation once control passes to it. For example, special rules can be inserted to guard against spendthrift children, or children in law. Your accountant can advise you further on this.

The Family Trust as a Retirement Vehicle

Increasingly family trusts are being seen as retirement vehicles, either in conjunction with a self-managed superannuation fund or as an alternative to a self-managed superannuation fund. Family trusts have the advantages of being able to acquire assets from related parties, borrow money, hold lifestyle assets such as holiday homes and company cars and are not subject to heavy prudential regulation, and do not need to be audited each year.

Death Duties

There are no death duties or similar imposts in Australia at present. However, if death duties are reintroduced then the ownership of assets through family trusts may have some advantages over the ownership of assets by individuals.

Other Advantages

Other advantages of a family trust include:

(i) confidentiality of information, particularly regarding the financial affairs of the trust. There are no statutory disclosure requirements for trusts in the way that there are for companies under the ASIC database. There is also no requirement for a trustee dealing with other persons to disclose that it is acting as a trustee of a trust and not in its own right. Thus bank accounts can be opened, leases signed, investments made etc for the benefit of the trust without other people needing to know this. In most cases we suggest that they should not know that the trustee is acting for a trust;

(ii) there are no formal audit requirements. Accounts have to be prepared but this is only to facilitate the preparation of an annual income tax return;

(iii) the absence of any formal legislative framework, such as the Corporations Law, to control the activities of the trustee. Trusts are of course subject to the various Trustee Acts and all other relevant law for example, the Trade Practices legislation and the Income Tax Assessment Act. This makes trusts very flexible entities to use for your business activities);

(iv) the easy entry and exit of beneficiaries, particularly in terms of who gets income and capital each year and on the winding up of the trust;

(v) trusts are cheap to set up and run each year; and

(vi) trusts are relatively simple to wind up.

FAMILY TRUSTS HAVE THE ADVANTAGES OF BEING ABLE TO OLD LIFESTYLE ASSETS SUCH AS HOLIDAY HOMES AND COMPANY CARS...

What are the disadvantages of a Trust?

The major disadvantage of a trust is that it cannot distribute capital or revenue losses to its beneficiaries.

As a result, should a trust incur a net loss its beneficiaries will not be able to offset that loss against any other assessable income that they may derive.

Expert advice should be sought if it is expected that a trust may make a revenue loss or a capital loss for taxation purposes.

In whose name should assets be held?

The trustee is the legal owner of the trust's property. This means the trustee's name should appear on all ownership documents, such as shares in private companies, units in private trusts, or title deeds for land ownership.

You may add the tag "… as trustee for the (name) family trust" if you wish, and this has the advantage of informing or reminding all concerned that the asset is held on trust and does not belong to the trustee personally. However, in some cases this will not be possible. For example, most Title Offices will only register a title in the name of the trustee, i.e. the legal owner, and will not allow the tag "… as trustee for the (name) family trust" to be used.

Estate Planning: Testamentary Trusts

Family trusts are useful tools for estate planning purposes. This means that their benefits may be available to subsequent generations as well, long after the founders have passed on. This means assets left to children and grandchildren via family trusts can be protected against divorce, business failure and litigation.

It also means children under the age of 18 can get significant tax advantages: income derived from trusts created on death is excluded from the rules set out in Division 6AA of the Income Tax Assessment Act regarding the taxation of unearned income for minors. This means the penalty tax rate normally applying to unearned income of a minor does not apply to this type of trust.

Assets transferred to or acquired by a discretionary trust are not owned by any individual person. This means they are not controlled by an individual's person's will. Setting up a family trust and transferring assets to it does not mean that a will is redundant. The role of the family trust and its relationship with your will should be properly understood, and the two should as far as possible be consistent, both with each other and your general wishes and intentions.

Specific estate planning advice should be sought from your accountant if this is of concern to you.

ASSETS LEFT TO CHILDREN AND GRANDCHILDREN VIA FAMILY TRUSTS CAN BE PROTECTED AGAINST DIVORCE, BUSINESS FAILURE AND LITIGATION.

APPENDIX 1:

THE DUTIES OF A TRUSTEE

The dominant duty of a trustee of a discretionary trust is to exercise the utmost good faith towards the beneficiaries at all times. This means the trustee must put the interests of the beneficiaries ahead of his or her or its interests at all times and generally act in a competent and responsible manner.

More particularly, the duties of a trustee include:

- to be familiar with the terms of the trust. The best way to do this is to read the trust deed and to ask your accountant questions if the meanings of the various clauses are not clear;
- to hold and manage the trust property. This includes making sure all relevant records show the trustee as the owner of the trust property;
- to observe the trust deed. Any procedures or processes set down in the trust's deed should be observed at all times;
- to exercise reasonable care, in the sense of exercising the same care and skill that a reasonable man would take in respect of his own affairs. If there is any doubt as to what this standard is, it is safest to err on the side of caution and if necessary engage experts such as accountants and solicitors to help the trustee with the tasks at hand;
- not to delegate the trustee's duties except as permitted under the deed. But delegation does not mean abdication, and the trustee is still responsible for the delegated task being completed appropriately;
- to invest the trust's assets in accordance with the law of trusts and any special rules set out in the trust deed. Most trust deeds contain extensive investment powers, and permit a very wide range of investments to be made;
- to act impartially between the beneficiaries;
- to maintain proper and complete books of accounts including minutes of meetings of the trustees/directors of the trustee company. Minutes of meetings of the trustees/directors should be created and retained to record all major transactions entered into by the trustee. An example of a minute of a meeting to record a trustee's decision to acquire a property is included as appendix 3;
- to deal with the trust property properly and not for the trustee's own benefit;
- prepare and lodge a tax return for the trust each year, and generally comply with the income tax law and related laws;
- to keep the trust's assets separate from other assets owned by the trustee; and
- insure the trust's assets, where appropriate.

The above list may seem onerous but usually trustees have no problems meeting these standards.

Problems are only rarely encountered. Nevertheless a wise trustee will act conservatively and will create sufficient documents to show why and how a particular task was completed; acting on the assumption that one day he or she may have to demonstrate how the above duties were satisfied.

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