

Discretionary trusts

Features and operations

Key points

- Discretionary trusts are one of the most common structures for investment and business purposes in Australia
- One of the main benefits of a discretionary trust is the ability to distribute income of the trust (arising from its investment or business holdings) to a wide class of eligible beneficiaries to achieve a tax-effective outcome
- The use of a discretionary trust to hold assets can also be an effective risk management strategy because none of the beneficiaries have a defined or fixed interest in the trust assets

What is a discretionary trust?

1. Discretionary trusts provide for a very wide range of beneficiaries without any particular beneficiary having a fixed interest.
2. This means that the people who control the trust have a discretion to distribute income and capital to the designated range of beneficiaries on a flexible basis.

Main features

There must be a trust fund or property

3. With a discretionary trust, the initial trust property is a settlement sum (usually \$10).

There must be a trustee

4. The trustee is the legal owner of the trust property. While the title to the property is registered in the name of the trustee, the trustee holds the property for the benefit of the beneficiaries, subject to the duties and responsibilities outlined in the trust deed.

Beneficiaries

5. A trust must have identifiable beneficiaries. A discretionary trust will have a general class of discretionary beneficiaries.
6. It is usual to designate particular groupings of beneficiaries of discretionary trusts as 'primary', 'secondary' and 'tertiary' beneficiaries.
 - (a) Generally, the primary beneficiaries will be the parties who are the initial controllers of the trust.
 - (b) The secondary beneficiaries will usually be the children and other family members of the primary beneficiaries.
 - (c) Tertiary beneficiaries will generally be related companies, trusts, charitable organisations etc.
7. The trustee has an absolute discretion as to how income and capital of the trust is distributed on a year to year basis. Therefore, the trustee can distribute the whole or part of the income for a year and capital to any one of the primary, secondary or tertiary beneficiaries.
8. However, if there is no decision made as to how the income is to be distributed, the default beneficiaries (usually the primary beneficiaries) will share in the income equally.

Common features and terms for discretionary trusts

Settlor

9. Someone needs to pay the initial settlement sum of \$10. This person is required to sign the trust deed and is called the 'settlor'.
10. For tax reasons, the settlor should be a person who is totally unconnected with the parties setting up the trust or their family, for example a friend who is not a relative or the accountant or lawyer for the parties.

Appointor/Principal

11. Most discretionary trust deeds provide for a person known as the 'appointor' or 'principal' to have the power to change the trustee.
12. In the CGW Structures deed, the appointor can transfer the power of removal and appointment of trustee to a replacement selected either during the appointor's lifetime or in the appointor's Will.
13. The appointor generally has the ultimate control over the trust assets because of the power to change the trustee.

Practical aspects of trusts

14. The law of trusts is quite complex but, on a day to day basis, the use of the trust for investment and business purposes is relatively simple.

Flexibility

15. One of the major advantages of a trust structure is its flexibility. This cannot be over-emphasised in a business or tax environment where legislation and other requirements change rapidly and sometimes retrospectively.
16. A discretionary trust allows the parties the opportunity to assess their tax position on a year by year basis and to distribute income in a different way each year (if appropriate) to achieve the most effective after-tax distribution of income.

Control

17. There is a concern among some clients that using a trust will result on their losing control of their investments or business. This is not the case.
18. Clients can retain total control by holding the position as appointor/principal. This control can be passed on either during their lifetime or under their Will.
19. No discretionary beneficiary has any interest in the trust assets except to the extent that the trustee (who is controlled by the clients) makes the conscious decision to exercise a discretion in favour of that beneficiary.

Risk management

20. Accumulating assets in a discretionary trust can be an effective risk management strategy because, as outlined above, none of the beneficiaries have a defined interest in the trust assets but merely a right to have the trust administered in accordance with its terms.
21. Therefore, if a beneficiary becomes bankrupt, the assets in the trust may be protected to some extent from claims by a trustee in bankruptcy.

Unpaid distributions

22. You should regularly review the balance of any loan accounts in favour of beneficiaries.
23. The trust deed provides that distributions of income do not actually have to be paid out to beneficiaries but may be recorded as journal entries with the amount of the income distribution being left as a loan owing to the beneficiary.
24. Therefore, if amounts are distributed to beneficiaries on a regular basis without cash actually being paid out, the amount of the unpaid distributions may become significant.
25. It is important to realise that any loan accounts are immediately due and payable if the beneficiary makes demand for payment after reaching the age of 18 years.
26. It is therefore important to monitor the level of all loan accounts in a trust (preferably on an annual basis) as steps can be taken to make sure that the amount of the loan accounts is kept under control.

Liability of trustees/directors

27. The trust estate itself is not a separate legal entity. It is the trustee who holds the trust property and is responsible for trust liabilities.
28. All transactions entered into in respect of the trust are entered into by the trustee, which is personally liable for those transactions.
29. Where individuals are trustees, they will be personally liable for all debts of the trust.
30. If the trustee is a company, the directors of the company are subject to the normal obligations and liabilities of company directors.
31. However, the trustee (and therefore the directors) is entitled to be indemnified out of the assets of the trust for all liabilities properly incurred in carrying on the trust activities.
32. Under the CGW Structures deed, the trustee does not have a right of indemnity personally against any of the beneficiaries. The right of indemnity is limited to the extent of the trust assets.
33. Therefore, creditors of the trust are also limited in their claims to the assets of the trust and cannot sue the beneficiaries personally unless the beneficiaries also happen to be directors or have provided personal guarantees.
34. Where a company acts as trustee, the directors may be personally liable for debts incurred by the trustee in circumstances prescribed by the *Corporations Act 2001* and other Acts that impose personal obligations on directors. However, the extent of the liability of directors of a corporate trustee is not any greater than the liability that would attach to the directors of a normal company.
35. Essentially, directors will not be personally liable where the company is entitled to an indemnity from the trust assets and the directors have discharged their duties (subject to some exceptions).

Taxation treatment of trusts

36. The provisions governing the taxation of trust income are contained in a separate division of the *Income Tax Assessment Act 1936*.
37. Although the trust is not a separate legal entity, the trustee is required to calculate its 'net income' as if it were a separate taxpayer for the purposes of the tax law.
38. Generally, the trustee is not taxed on its income. The procedure is that the income is distributed to various beneficiaries, who are then taxed on their share of the income. One exception to this is if income is distributed to children who are beneficiaries but who are under the age of 18 years. In those cases, the trustee will be assessed.
39. If a child under the age of 18 receives distributions in a financial year that are less than a total of approximately \$416, no tax will be payable. If distributions above this figure are made to a child in a financial year then, generally, that distribution will be taxed at the top marginal tax rate.
40. If for any reason, the trustee elects not to distribute part of the trust income but to accumulate it within the trust, then that accumulated income is also taxed at the top marginal rate.
41. It is important that decisions on the distribution or accumulation of income are properly minuted by the trustee before the relevant due dates each financial year, which is generally before 30 June.

Land tax and duty

42. Each state and territory in Australia has a different regime that governs the land tax and duty treatment of investment by trusts in real property, including the way in which foreign duty and land tax surcharges apply.
43. If you are intending on acquiring real property in a particular state or territory, you should ensure that the trust deed includes the specific provisions required by the relevant state or territory so that additional duty and land tax is not payable (where possible).

44. As the regime in each state and territory is different, it is best practice for separate trusts to be set up for the investment in each different jurisdiction, with each trust containing the restrictions necessary for that jurisdiction.
45. For example, in Queensland, if each of the default beneficiaries are Australian citizens and they do not renounce their citizenship, the trust will not be liable for foreign duty or land tax surcharge in Queensland. However, in New South Wales and Victoria, it is also necessary to permanently exclude all persons who are not Australian citizens or permanent residents, and any permanent residents who fail to satisfy an ordinarily resident in Australia test, as beneficiaries of the trust. If the trust deed does not contain those exclusions, it is deemed to be a 'foreign trust' (even if none of the current beneficiaries are foreign persons) and a foreign duty surcharge and a foreign land tax surcharge will apply (unless the trust can satisfy a specific exemption).

Administration

46. The trust should have a bank account, which should be opened in the name of the trustee acting as trustee.
47. If a company acts as trustee, it will be necessary to pay the annual review fee to the Australian Securities and Investments Commission and to comply with the administrative requirements of the *Corporations Act 2001* (Cth).
48. The trustee will be required to prepare and lodge tax returns on an annual basis. As indicated above, the trustee is not generally taxed on the income but the ATO requires that returns are lodged on behalf of the trust so it can calculate the tax payable by the beneficiaries on their share of the income of the trust.

Effect on your Wills

49. We recommend that you review your Will once you have established a trust.
50. If you hold assets in a trust structure, those assets are outside the scope of your Will. The assets that you can dispose of in your Will are the shares in the trustee company (if any). If you are the appointor under the trust, you may wish to nominate a replacement trustee or appointor in your Will.
51. The persons who hold the shares in the trustee company or are the appointors of the trust effectively control the trust and are therefore in a similar position to the executors under your Will. Therefore, some care is needed in drafting the Will to ensure that the trust assets are properly administered and disposed of in accordance with your wishes.

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