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Wealth & Advisory

Family trusts

The term family trust refers to a discretionary trust set up to hold a family's assets or to conduct a family business. The ability to arbitrage tax between family members, protect assets from creditors, and help with succession planning makes them as useful as ever in wealth creation. For tax purposes though, a trust is not considered a “family” trust until a “Family Trust Election” is made.

How to establish a discretionary trust

There are four roles involved in the establishment of a discretionary trust:

a. The Settlor
The settlor is the person who creates the trust by “settling” a sum of money or item of property on trust for the beneficiaries.

b. The Trustee
The trustee is the legal owner of the trust property although not the beneficial owner. The trustee carries out all transactions of the trust in its own name and must sign all documents for and on behalf of the trust. The trustee’s overriding duty is to obey the terms of the trust deed and to act in the best interests of the beneficiaries.

c. ***The Appointor***
The Appointor is the person named in the Trust Deed who has the power to remove and appoint trustees. This would commonly occur when:

- the trustee dies, becomes bankrupt or is incapacitated;
- in the case of a company, the company is wound up.

d. ***The Beneficiaries***
The beneficiaries are the people (including entities) for whose benefit the trustee holds the trust property. The beneficiaries of a discretionary trust do not have an interest in the assets of the trust. They merely have a right to be considered or a mere expectancy until such time as the trustee exercises its discretion to make a distribution.

The general beneficiaries are those beneficiaries named in the trust deed who are eligible to receive a distribution of income or capital at the discretion of the trustee (subject to the approval of the Appointor). The remainder beneficiaries are the beneficiaries automatically entitled to receive a proportionate distribution of income or capital to the extent that the trustee has not exercised its discretion otherwise.

Benefits

- Asset protection. Assets held in a family trust cannot be attacked by creditors or lawsuits so they are ideal for protecting assets from business or personal disputes and they can also facilitate the transfer of assets from generation to generation tax free. Another area family trusts can be helpful is with “spendthrift children”. If the assets were distributed immediately to children, there is always the risk that some of the children may spend the funds on “wasteful things”. Furthermore, by housing assets in a discretionary trust, there is a much greater safeguard (virtually guaranteed) that the children will not realise the assets to switch to another investment or another asset class. For example, it provides greater assurance for farming families that the farm will not be transferred outside the family.
- Cost effective. The cost of establishing a family trust is relatively low. A trust generally can cost between $500 and $2,000 in legal documentation with accounting fees varying between $500 and $2,000 each year.
- Tax minimization. Trust distributions can be directed to family members on lower tax rates, potentially saving you thousands of dollars in tax because the trustees of the trust have the “discretion” to distribute income and capital as they see fit – and no beneficiary has a fixed entitlement to receive anything – the trustees are able to “stream” income in a tax effective way on a year to year basis.
- Retirement planning. While the superannuation rules continue to change, a trust provides a flexible structure to accumulate long term wealth with tax benefits. Consider accumulating funds both in your super fund and also within your trust. Unlike your superannuation fund, your trust doesn't have any rules about when you can access the funds and can provide for an early retirement prior to gaining access to your super fund monies.
- Flexibility and estate planning. Most family trust deeds are flexible in their operation and can provide for good estate management, allowing for assets to benefit generations without the need for ownership to change from one individual to the next.

How it works

While any kind of trust can elect to be a family trust, the need to pass the family control test restricts the choice to a trust that is not widely held and where a specific family effectively controls the trust.

An Australian family trust:

- is generally established by a family member for the benefit of members of the 'family group'
- can be the subject of a family trust election which provides it with certain tax advantages, provided that the trust passes the family control test and makes distributions of trust income only to beneficiaries of the trust who are within the 'family group'
- can assist in protecting the family group's assets from the liabilities of one or more of the family members (for instance, in the event of a family member's bankruptcy or insolvency)
- provides a mechanism to pass family assets to future generations, and
- can provide a means of accessing favourable taxation treatment by ensuring all family members use their income tax "tax-free thresholds".

The terms and conditions under which a family trust is established and maintained are set out in its deed.

The trust is established by the trust's settlor and trustee (or trustees) signing the trust deed, and the settlor giving the trust property (the "settled sum") to the trustee.

The settlor's function is to give the assets to the trustee to hold for the benefit of the trust's beneficiaries on the terms and conditions set out in the trust deed. The settlor executes the trust deed and then, generally, has no further involvement in the trust.

The trustee is responsible for the trust and its assets. The trustee has broad powers to conduct the trust, and manage its assets.

A trust does not have to pay income tax on income that is distributed to the beneficiaries, but does have to pay tax on undistributed income. The trustee is free to distribute trust income to as many beneficiaries as possible, and in proportions that take best advantage of those beneficiaries' personal marginal tax rates. The beneficiaries then pay the tax on distributions made to them. Undistributed income is taxed in the hands of the trustee at the top marginal tax rate, giving a strong incentive to family trusts to fully distribute the trust's income before the end of each financial year.

Distributions received from a trust are not a special form of income, but instead form part of a beneficiary's assessable income. If the beneficiary receives income from other sources in addition to distributions from the trust, all of the income will be taxed together.

Even if the beneficiary's income does exceed the tax-free threshold for a particular year, the rate of tax applied to the amount of the excess income over the tax-free threshold may be lower than for other beneficiaries because of the total income that these other beneficiaries already receive.

All distributions must be made only to people who qualify under the terms of the trust deed to be beneficiaries of the trust and who are within 'the family group'. If a family trust makes a family trust election and then pays out to someone not a member of the family group, they will be taxed at the maximum rate possible. The trustee should also take care in relation to which beneficiaries are chosen to receive distributions, as penalty tax rates can apply to distributions made to minors.

Consequences

- When trust income is not distributed, the trustees themselves are liable to tax on the undistributed income – and a rate of tax usually higher than the beneficiaries themselves would have to pay.
- Disputes can arise where control of the trust is passed down to the next generation. The problem is the assets are all tied up together and when moving from the first generation to the next, the assets will need to be controlled by and distributed.
- It is always important distributions are made in accordance with the Trust Deed and the proper records are kept regarding distributions. Distributions of income which are decided upon but not paid to the beneficiary become a debt owing by the trust to that beneficiary and you need to obtain advice from an accountant to ensure you are complying with the taxation legislation in this regard.
- Buying a property in a family trust does not qualify you for the first homeowners grant or stamp duty concessions.

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