

What is a Discretionary Trust?

TRUST

Why a Discretionary Trust?

Many clients find it difficult to understand the concept of a discretionary trust and the relationship with the trustee of that trust, especially when the trustee can be a company for asset protection reasons.

In Australia, a discretionary trust is a common structure to run a business out of because it offers many taxation advantages, for example: the flexibility to distribute profit to different beneficiaries (including streaming of dividends to a particular individual(s)), the ability to access significant capital gains tax concessions and stream those capital gains to a particular beneficiary.

What is a Trust?

A trust is simply an agreement whereby a person or company agrees to hold an asset for the benefit of others. The person or company who controls the asset is known as the 'trustee' and those who benefit are called the 'beneficiaries'. The creator of the trust sets out specific terms how the assets are to be managed in a document called the 'trust deed'.



How is a Trust established?

The Trust is established by an independent person (the Settlor) who makes a gift of a sum of money (the Settled Sum) to a person or company (the Trustee) for the ultimate benefit of nominated persons (the Beneficiaries) at some future time (the Vesting Day) under conditions which are evidenced in writing by the Settlor in a Deed. The Settlor is usually your accountant or lawyer because the Settlor can't be a beneficiary of the trust.

The Trustee may then acquire other income producing assets, including a business, for the benefit of the Beneficiaries upon the terms set out in the Deed.

A Trustee can, on behalf of the trust conduct a business operation, own shares in operating companies, own rent producing properties, carry out speculative ventures or any other activity that a company or individual can conduct without becoming liable to the income tax applicable to proprietary companies, i.e. the trust itself lodges a tax return and distributes profit to the Beneficiaries. A company acting solely as trustee generally does not need to lodge a tax return itself.

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Structure of a Discretionary Trust

Settlor

- Gifts the initial trust property to start the trust.
- This is the only duty of a Settlor.
- Can be an accountant, lawyer or friend.
- Cannot be a Beneficiary.

Appointor

- Controls the Trustee (appoint and replace the Trustee).
- Usually held in joint names (husband and wife).

Trustees

- Usually an individual (husband and/or wife) or a company.
- Have the discretion to select which Beneficiaries receive income and capital (it does not need to be divided equally).
- Holds assets (investments or business) on behalf of the Trust.

Trust fund

- Income is received and can be allocated to Beneficiaries.
- Income that is not distributed is taxed at the highest marginal tax rate.
- Transfer of assets to or from the Trust may attract CGT and/or Stamp Duty.

Beneficiaries

- Receive income distributions from the Trust Fund as allocated by the Trustee.
- Income received becomes part of assessable income.
- Can be children, grandparents, parents, siblings, spouse, grandchildren or any de facto spouses of family members.

Roles, responsibilities and terminology

The following should assist you in understanding the mechanics of the formation and operation of the Trust.

1. Settlor

The Settlor is the person who initiates the formation of the Trust by the provision of the Settled Sum. Apart from providing the Settled Sum and executing the Deed of Settlement, the Settlor takes no further part in the Trust operations.

2. Appointor

The Appointor has power under the Deed of Settlement to remove and replace the Trustee as they see fit. Accordingly, the person holding the office of Appointor assumes indirect control over the whole operation of the Trust.

We generally recommend joint Appointors or at least a clear succession should the Appointor die. If there is no nominated successor, the Appointor's legal personal representative succeeds as the Appointor. Where an Appointor loses capacity (e.g. suffers dementia) and where an enduring power of attorney is in place, the attorney succeeds as the Appointor.

3. Guardian

Many modern Deeds have done away with the appointment of a Guardian.

We do not refer to this appointment further in this document.

Where found, this office is nominated under the Deed of Settlement and gives consent to distributions of income and capital by the Trustee. Certain powers conferred on the Trustee by the Deed of Trust may be exercised only with the consent of the Guardian.

4. Trustee

The Trustee may either be a natural person or persons or, alternatively, a proprietary limited company usually incorporated specifically for the purpose of acting as Trustee. The Trustee can be liable for any of its actions in its capacity as Trustee (e.g. negligent acts, misrepresentations, fair trading breaches and for liabilities to unpaid creditors including the Tax Office, etc). Therefore, many business trusts have a "\$2 company" acting as Trustee rather than having an individual trustee, whose personal assets could be exposed.

Where it is proposed to use the Trust as an asset holding vehicle or a trading vehicle, it may be appropriate to appoint a company as Trustee. This may avoid confusion between Trust assets and non-trust assets and also attracts the limited liability protection of a company.

Any individual discharging the function of a Trustee should always make it clear to other parties that he is acting in his capacity as a Trustee of the Trust, otherwise he may attract direct personal liabilities.

The Trustee is the legal owner of all property comprised in the Trust Fund, but that legal ownership is only held in the favour of those persons specified in the Trust Deed as Beneficiaries.

5. Beneficiaries

Beneficiaries are defined in the Trust Deed.

As the Trust is a discretionary trust (as opposed to say a fixed unit trust), no Beneficiary has a vested interest in the Trust Fund and no Beneficiary can require the Trustee to exercise his discretion to appoint income or capital in his favour. The only right that a Beneficiary has is to require the Trustee to exercise his discretion bona fide and in good faith.

Under the terms of the Trust, income may be distributed as desired annually, or accumulated with a view to achieving maximum tax advantages. These advantages are obtained by distributing the Trust income among the whole series of Beneficiaries so that the benefit of lower marginal rates of tax can be obtained. As a matter of practice, such distributions are simply reflected as book entries in the Trust books of account. Any one or more Beneficiaries can be excluded from the annual distribution as considered desirable.

6. Vesting Day

The Vesting Day in Western Australia is 80 years from the date of commencement of the Trust. That is, as a matter of law, the Trust must terminate or 'vest' at a date not later than 80 years after its commencement. However, a provision may be included in the Trust, that enables the Trustee to nominate an earlier Vesting Day.

We generally recommend joint Appointors or at least a clear succession should the Appointor die.

How does it work?

The Trustee will contract on behalf of the trust in accordance with the terms of the Trust Deed. The Trust is required to get a Tax File Number (TFN) and where relevant, an Australian Business Number (ABN), GST registration etc and lodge a tax return. Other than that, there are no legislative provisions for registration of trusts and the naming of a trust is a question of personal preference.

The Trust Deed confers on the Trustee wide powers, which are usually sufficient to cover most commercial undertakings, enabling the Trustee to deal with and manage the Trust.

It is the Trustee who is empowered to distribute the income and capital of the Trust Fund.

In any year, the Trustee may deal with the income of the Trust in the following manner:

- All or any part of the income may be paid out to any one or more of the Beneficiaries in such proportion as the Trustee in their absolute discretion decides;
- Any part of the income not paid out is divided equally and held in trust specifically for the Beneficiaries;
- If the Trustee so resolves in writing, all or any part of the income can be accumulated, in which case the income would currently be subject to a penal rate of tax under Section 99A of the *Income Tax Assessment Act*.
- The powers of the Trustee in dealing with the capital of the Trust Fund are as follows:
- The capital of the Trust Fund is distributed on the Vesting Date amongst the Beneficiaries nominated in the Deed (or, if they are deceased, among their children or grand children) in equal shares, unless the Trustee, by Deed made prior to the Vesting Date appoints the capital in favour of the Beneficiaries in other specified proportions.
- Any part of the capital may be advanced for the benefit of one or more of the Beneficiaries from time to time at the discretion of the Trustee.



Safeguard and control

The person who holds the office of Appointor can effectively regain control of the Trust assets by resettling the Trust Fund to another Trust.

Review

Legislation affecting discretionary trusts is often the subject of Parliamentary review. Trustees should therefore review trust deeds regularly to ensure that the trust remains relevant and is an effective structure that can be adapted to changed business, family and legislative environments.

You should periodically seek advice on the suitability of the structure, particularly where financial or family situations change in subsequent years.

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For further information, or to discuss your business structure and assistance with setting up a Trust, please visit our website:
www.moorestephens.com.au

Moore Stephens WA

Level 15, Exchange Tower, 2 The Esplanade
Perth, WA 6000
T +61 (0)8 9225 5355
perth@moorestephens.com.au

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