HOW TO USE TRUSTS TO YOUR ADVANTAGE

Robert Minter*

There is no magic to trusts. Every superannuation fund is a trust and every will creates a trust. Family trusts are a type of trust that allows income to be distributed between family members in the most tax effective way while ensuring that family assets are protected in the event of marriage breakdown, creditor's claims and will disputes. When a family trust is created under a will, tax free distributions can be made to children under 18. Family trusts have become a fundamental part of modern estate planning and business structures.

A trust is essentially when someone (the trustee) holds something for you; you are the real owner. Even though trusts have to lodge tax returns, a trust is actually not a legal entity. The trust is represented by the trustee, often a company, which is the legal entity.

A trust can be created by deed or in a will (testamentary trust). There are many types of trusts including superannuation trusts, hybrid trusts and trusts for disabled persons.

A "unit trust" is a type of trust where the beneficiaries are the owners of the trust assets in proportion to the number of units they hold. Unit trusts are popular as commercial investment vehicles.

A hybrid trust combines the elements of a fixed or unit trust but also gives the trustee some level of discretion

What are family or discretionary trusts?

The term *family trust* generally implies a discretionary trust. Unlike all other trusts, the trustee of a discretionary trust is essentially the owner of the trust assets because it has absolute discretion to decide to whom it will give the trust income each year.

Because of this, no beneficiary has any claim on trust income or capital and accordingly it cannot be said that any particular beneficiary owns the trust assets. It is for this reason that tax benefits and creditor protection flows.

Family trusts are one of the most common asset protection and estate planning tools as they offer the following benefits:

1. they enable income to be distributed in the trustee's discretion each year for the best tax advantage;
2. they can offer lower capital gains tax on business sales;
3. they protect family assets in the case of financial difficulty, divorce or bankruptcy;
4. they provide a tool to deal with family members who may be considered financially irresponsible;
5. they provide a formal management structure for an elderly member of the family who might suffer dementia, incapacity or become vulnerable; and
6. help to avoid will disputes.

An example of how trusts are used in a practical context is in the case of rural families. Country properties are often held in a family trust so that they will be protected over the generations against marriage breakdown or financial difficulty. The current generation will manage the farm and can, with their spouse, receive all or any of the income while still allowing payments to other family members where tax or reasonableness warrants.

Because all family member's receipts are dependant on the discretion of the trustee none can be said to own any part of the trust assets. Therefore if, say, due to drought, a family member goes broke the farm will not be included in his assets for distribution to creditors. Likewise, if there is a divorce in the family, the farm will not be distributed as a personal family asset.

The principles that apply to the family farm apply similarly to any family's business and financial arrangements.

Divorce and Trusts

As something like 40% of marriages fail, a family trust can help to ensure that the trust's assets are protected against family court orders thereby avoiding dispersal of family assets to non family members on dissolution of a beneficiary's marriage.

Trusts are used as a basic tool in the case of blended families to predetermine what the members of the first family are to receive and avoid will disputes.

The Family Court is nevertheless entitled to deem a beneficiary the "owner" of trust assets if they are in a position to *control* the trustee in some way. Under section 79 of the Family Law Act, the court may even consider trust assets to be a "financial resource" and take the existence of a trust into account when dividing assets. It is therefore necessary that trusts be carefully set up.

Claims under Wills

Will disputes are extremely common and as the estate often pays court costs there are often opportunistic claims on estates in the hope that the claimant will be "paid off".

If assets that are held separately in a trust they will not be part of a person's estate and therefore will not be part of any claim against the estate provided the issue of "control" mentioned above is dealt with.

Protective trusts must be set up before death because any trust set up in a will can be subject to a will claim before that trust even comes into existence.

Business and Trusts

To obtain the benefits of limited liability most businesses are owned by a company. The downside is that company's pay capital gains tax on 100% of the gain whereas people currently pay CGT on only half.

It is therefore common for companies to own the business but create an underlying unit or discretionary trust in favour of individuals. This permits the business income to be distributed to individuals, and family members allowing any capital gains to be taxed at the concessional rate.

If a trust has held a "small business" for 15 years, capital gains tax on transfer may be completely disregarded and even if the business has not been held for 15 years the small business retirement exemption for a capital gain of up to $500,000 per individual will not be lost merely because the business is owned by a trust.

Because trusts are obliged to pay a higher rate of tax on retained income they are more suitable for passive investments such as property holdings tax and less suitable for active businesses where the income needs to be retained, say for reinvestment.

Who should be the trustee?

The trustee controls the trust. The trustee of a family trust is generally a company because it will continue beyond the original founder's death or incapacity.

But as individual shareholders and directors do not enjoy the same indefinite lives and it is they who control the trustee company appropriate succession arrangement are most important.

It is clear therefore that the principal of the trust must ensure in his or her will that the shares in the trustee company are passed on to the most appropriate person.

What is a testamentary trust?

While a testamentary trust technically means any trust that is set up under a will people often use the term to refer to a family trust in a will.

Such trusts offer all the benefits of family trusts mentioned above but also the benefit that income can be distributed to minors at non-penalty rates. This means that $18,200.00 (rather than $416.00) can be paid to a minor tax free each year. Under an inter vivos trust the tax free threshold for distributions to minors is only $416 per annum. Testamentary trusts will therefore offer significant benefits in many family situations.

A testamentary trust could, by way of example, allow a grandfather make a meaningful gift to his grandchildren whilst still benefitting his own children and still leave a fund to initially provide financially for his widow and protect those assets for the future against her possible dementia and those that prey on the elderly.

Where does Superannuation fit in?

Many people do not realise that assets held in a superannuation fund, pass independently of their will. This means that when determining what you want to do with your assets you need to deal with your superannuation separatly to, or together with, your will.

Superannuation funds are required to be cashed in on the member's death unless there is a spouse, child or dependant. To ensure that super funds pass to the required beneficiary a binding death nomination in favour of that person is required.

There will come a time when there will be no relatives who can be classed as dependants and at some point the nomination will need to nominate the personal representative under the will as the recipient of the super funds. At that point the super funds will be distributed in accordance with the terms of the will.

As tax is payable (on the untaxed portion) of super funds where those funds are not paid to a spouse or dependant good estate planning warrants asking whether the super fund should be wound up before the member's death while the fund has tax free status.

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Many people say that they do not want to "rule from the grave" but there is often good reason to do so at least in a targeted way. Estate planning should aim to ensure that financial arrangements made during life are seamlessly carried forward after death. Trusts are one means by which hard earned and easily lost assets can be protected for the benefit of future generations against tax imposts and the vagaries of life including incapacity, divorce, creditors, bankruptcy and opportunists.

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