Trusts: Know the basics

Factsheet
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Trusts can be an effective way to protect your financial and business assets, and provide certain tax outcomes, depending on how they are structured. This factsheet is a basic guide to trusts, their benefits and some different types of trusts.

What are trusts?

Trusts are widely used for investment and business purposes.

A trust is an obligation enforceable against a person (the trustee, who may be a natural person or some other legal entity) to hold property of the trust for the benefit of some other person/s (the beneficiary/ies) or for the advancement of certain purposes (e.g. in the case of charitable trusts). While in legal terms a trust is a relationship not a legal entity itself (unlike, for example, companies which are separate legal entities), trusts are treated as taxpayer entities for the purposes of tax administration.

The settlor

Trusts can be created in multiple ways. A common method is for a settlor to create a trust by the transfer of property (often via a nominal sum of money such as $20) by the settlor to a third party, who agrees to act as a trustee and hold the trust property held on the terms set out in a written declaration (trust deed) which details the powers and duties of the trustee, and provisions relating to the operation of the trust for the benefit of defined beneficiaries. For tax reasons, the settlor tends to not be a beneficiary of the trust.

Trusts can also be created by other means such as via a Will. These trusts are known as testamentary trusts. For more information on different trust structures, see our separate factsheet: Types of trusts.

The trustee

The trustee(s) of a trust may be one or more individuals or a company (the latter is known as a corporate trustee).

The trustee holds the legal title in trust property for the benefit of the beneficiaries in accordance with the terms of the trust deed and is recognised by law as the legal owner of the trust property. The trustee/beneficiary relationship is a fiduciary relationship whereby the trustee is obligated to act in the best interests of the beneficiaries of the trust.

The trustee must also act in accordance with the relevant state or territory law regulating trusts, and with any other applicable law, including superannuation or tax law (as applicable).

Under trust law, trustees are:

- personally liable for the debts the trustee incurs in the course of administering the trust, and
- entitled to be indemnified out of the trust property for liabilities incurred in the proper exercise of the trustee's powers (except where a breach of trust has occurred) or as otherwise provided for in the trust deed (the trust deed may contain a broader right of indemnity in favour of the trustee).

The trustee is responsible for managing the trust's tax affairs, including registering the trust in the tax system and lodging trust tax returns.

The beneficiaries

A trust beneficiary can be a person, a company or the trustee of another trust. The trustee may also be a beneficiary (but not the sole beneficiary unless there is more than one trustee and there may be tax and duty reasons for the trustee being excluded as a beneficiary).

Beneficiaries may have a fixed entitlement to trust income or capital that is set out in the trust deed (as is the case in fixed trusts such as a unit trust) or such an entitlement may arise because the trustee exercises a discretion to pay them income or capital (as is the case for beneficiaries of discretionary trusts (also known as family trusts)).

Generally, the beneficiaries are taxed on the net income of a trust based on their share of the trust's income distributed to them in a particular financial year – regardless of when or whether the trust distribution is actually paid to them. Beneficiaries (except some minors and non-residents) include their share of the trust's net

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income as income in their own tax returns. There are special rules for some types of trust including deceased estates and super funds (which are a type of trust).

The trust property

This is the asset/s that is/are subject of the trust. This can include assets such as real estate, cash and shares.

The trust deed

The obligations of the trust are typically documented in the trust deed, which sets out how the trust should be run and the responsibilities and rights of the trustee and beneficiaries. The trust deed should be drafted by a lawyer as it will govern the rules of the trust.

The appointer

The appointer is the person who under the terms of the trust deed generally has the power to appoint and remove the trustee. Not all trusts have an appointer, in which case the applicable trust legislation will generally apply to determine who may exercise these powers.

What are trusts used for?

Trusts can be used for business and investment purposes for asset protection reasons, to provide flexibility over income distributions and to achieve certain tax outcomes.

Asset protection

Depending on how the trust is structured, there can be various levels of asset protection:

- In the case of a discretionary trust, trust assets may be protected from claims (e.g. by a trustee in bankruptcy) made against a beneficiary in their personal capacity. Depending on the trust's structure, as the beneficiary does not own the trust property (any entitlement they may have is dependent on the trustee exercising its discretion in favour of that beneficiary), creditors of the beneficiary may find it challenging to seize assets of the trust to satisfy debts of the beneficiary.

  For example, Dr Geoffrey uses an appropriately structured business trust to operate a successful medical practice. Dr Geoffrey has also borrowed substantial sums of money in his personal name to invest in properties and shares which have performed extremely poorly resulting in Dr Geoffrey defaulting on the loan and the bank commencing proceedings to recoup the amounts owed personally by Dr Geoffrey. As Dr Geoffrey does not own the medical practice in his personal name, the assets of the business may be protected from creditors and Dr Geoffrey may be able to continue to work in the business without the business being affected by the proceedings.

  This is a simplified explanation of the asset protection benefits of a trust and in practice the particular circumstances will be relevant in determining whether trust assets will be protected from a beneficiary's personal risks. Specific legal advice should be sought when structuring your business affairs to address any asset protection concerns.

- Assets may be protected in family law property proceedings (ie upon the breakdown of a relationship) which may make it more difficult to obtain a Family Court order affecting trust assets.

  However, the Family Court may take into account the trust assets for the purposes of apportioning marriage assets, either by making appropriate orders in respect of one of the spouse's personal assets (where the Court considers the trust assets are a financial resource of that spouse) or by directly making an order affecting trust assets (where the Court considers the trust assets are the property of a party to the relationship - for example where one of them has a high level of control over the trust, such as where they are the sole trustee, the appointer, a beneficiary and there is a pattern of distributions).

  For example, Dr Smith's parents have an appropriately structured trust (i.e. Dr Smith is not a trustee or appointer there is no pattern of distributions to Dr Smith) which holds significant investments. Dr Smith's marriage fails and Dr Smith's spouse seeks a property order taking into account the trust assets. Given the trust is appropriately structured and there is no pattern of distributions to Dr Smith, it is unlikely such an order will be made.

Flexibility of income distributions and tax treatment

Trusts may provide flexibility to distribute income and/or capital to one or more beneficiaries in a tax effective manner. Trusts may also have access to certain capital gains tax (CGT) concessions, including small business tax concessions and tax effective retirement planning opportunities.

Further information on the taxation treatment of trusts is outlined below.

How are trusts taxed?

This differs, depending on the type of trust. The sections below summarise the tax treatment of income, franked distributions, capital gains and losses of trusts.

Tax treatment of income

The net income of a trust (effectively its taxable income) is its assessable income for a financial year less allowable deduction worked out on the assumption that the trustee is a resident (even if the trustee is actually a non-resident).

Because the income of a trust is determined in accordance with the trust deed and its net income is determined in accordance with income tax law, the two amounts may be different (although many trust deeds adopt the tax law meaning).

Generally, the net income of a trust is taxed in the hands of the beneficiaries (or the trustee on their behalf) based on their share of the trust income (that is, the share they are 'presently entitled' to) regardless of when or whether the income is actually paid to them.

For example, if the beneficiary has a 50% share of trust income, they are assessed on a 50% share of the trust net income. This is referred to as the proportionate approach.

Special rules apply to franked distributions and capital gains included in the trust's net income.

A beneficiary is presently entitled to trust income in a financial year where they have, by the end of that year, a present or immediate right to demand payment from the trustee. The entitlement will depend on the trust deed and any discretion that the trustee has under the deed to allocate income between beneficiaries.

The trustee will need to provide each beneficiary with details of their share of the net income, so that the beneficiaries can include this amount in their tax returns.

Tax rates

Adult and company beneficiaries pay tax on their share of the trust net income at the individual income tax rates that apply to them. One of the benefits of discretionary trusts is the ability to "stream" income to beneficiaries on lower individual income tax rates. For example, Dr Johns' medical practice is run through a family trust. Dr Johns is on the top individual income tax rate and would therefore pay tax at the top rate on any trust distributions but Dr John's spouse and adult children who are at university do not work. It would be tax effective for Dr Johns and the family group, for the trustee to distribute trust income to Dr John's spouse and adult children to take advantage of their lower individual income tax rates.

The trustee pays tax on behalf of non-resident beneficiaries and those who are minors, based on their share of the trust's net income (by withholding an appropriate amount from the trust distribution and remitting that withheld amount to the Australian Taxation Office). These beneficiaries may need to declare their share of the trust's net income in their own income tax returns, and can claim a credit for the tax paid/withheld on their behalf by the trustee.

Higher rates of tax apply to most trust distributions to minors to discourage adults from diverting income to their minor children. This is summarised in the table below.

Eligible taxable income	Tax payable
Up to $416	Nil
$417 - $1,307	Generally 66% of the excess over $416
Above $1,307	45% of eligible taxable income plus Medicare levy

(as of 1 November 2019)

There are certain types of 'excepted income', where a minor may be taxed at the same rate as an adult, including access to the standard tax-free threshold ($18,200 in FY20). One example is income from a deceased person's estate where there is a testamentary trust in the deceased's Will.

If there is any part of the trust's income to which no beneficiary is presently entitled (for example if it is accumulated and not distributed), the trustee is taxed on the corresponding share of net income. If there is no trust income the trustee is taxed on any net income. The trustee is generally taxed on the trust income at the highest individual income tax rate that applies to individuals, so there is a disincentive from a tax perspective to accumulate income.

Franked distributions

Unless prevented by the trust deed, a beneficiary may be made specifically entitled to a franked distribution, resulting in the beneficiary being taxed on the franked distribution. If a beneficiary qualifies for a franking credit offset, they are also required to include the amount in their assessable income. This allows distributions to be made to beneficiaries who are best placed to take advantage of any corresponding franking credits.

If no beneficiary is specifically entitled to a franked distribution, it is taxed proportionately to all beneficiaries based on their entitlement to the trust income (with some modifications). That is, in much the same way as the other net income of the trust.

You should discuss with your accountant making a family trust election otherwise a beneficiary without a fixed entitlement to the franked distribution may only be able to use the associated franking credits in limited circumstances (for example, where their total franking credits from all sources in a financial year is $5,000 or less).

Losses

A loss made by a trust in a financial year cannot be distributed to beneficiaries. However, it can be carried forward and used to reduce the trust's net income in a later financial year.

Trust capital gains and losses

Disposal of a trust asset (or another CGT event) is likely to result in a capital gain or loss for the trust (unless a beneficiary is absolutely entitled to the asset).

Capital gains and losses are taken into account in working out the trust's net capital gain or net capital loss for a financial year as follows:

- a net capital gain is included in the trust's net income, or
- a net capital loss is carried forward and offset against the trust's future capital gains.

As part of the net income of a trust, the net capital gain for the financial year is then allocated proportionately to beneficiaries based on their entitlements to trust income – unless:

- there is a beneficiary that is specifically entitled to the capital gain, or
- the trustee (of a resident trust) chooses to be taxed on a capital gain. This choice can be made provided all or part of an amount relating to the gain has not been paid to, or otherwise allocated for the benefit of, a beneficiary during or within two months of the end of the financial year. This rule allows the trustee to choose to pay tax on behalf of a beneficiary who doesn't immediately benefit from the gain.

If there is no beneficiary entitled to income (or specifically entitled to the capital gain) the trustee is taxed on the capital gain.

Where the trustee is taxed on trust net income at the top individual income tax rate under section 99A of the *Income Tax Assessment Act 1997* (Cth), they are not entitled to the CGT discount on the gain.

A capital gain can be streamed to a particular beneficiary by making them specifically entitled to the gain.

If a beneficiary is made specifically entitled to a trust capital gain, the capital gain is taken into account in working out their net capital gain for the financial year with the benefit of any discounts or concessions to which they are entitled.

Small business CGT concessions

Appropriately structured trusts may be able to access the small business CGT concessions. These include the 50% active asset reduction, the 15-year exemption, the retirement exemption and rollover relief. These concessions can provide substantial tax benefits to small business owners on the sale of a business.

Get advice that suits your situation

This factsheet provides an overview only of some of the notable aspects of trusts, their purposes and benefits, and some common types of trusts. Advice in this area is complex and we recommend you seek professional advice from a lawyer, accountant and financial adviser.

Good quality advice will confirm whether a trust is appropriate for your circumstances and goals, and that it is structured correctly to achieve your objectives. The team at Doctors Wealth Management can review your situation and recommend a solution for your individual circumstances.

You can find additional resources and information about Doctors Wealth Management at **doctorswealthmanagement.com.au** or call **1800 128 268**.