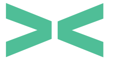

DOCSCENTRE

Discretionary Trust
Explanatory Notes

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1. Background

These notes describe the general nature and operation of your discretionary trust. If you are uncertain of the nature of any of the Trustee's powers, or whether a particular transaction may be lawful or appropriate, you should obtain professional advice as decisions made or discretions exercised by the Trustee may have significant tax and other consequences.

It is recommended that you read the Trust Deed carefully and discuss it with your adviser.

2. What is a trust?

A trust is an equitable obligation binding the Trustee to deal with trust property over which the Trustee has control for the benefit of named beneficiaries or classes of beneficiaries.

A trust is not a separate legal entity, even though, for tax law purposes, a trust tax return is required to be lodged.

3. What is a discretionary trust?

A discretionary trust is generally a trust under which the distribution of income or capital to beneficiaries is made at the discretion of the Trustee. Until the Trustee exercises its discretion, the beneficiaries generally have no interest in the property of the trust. A discretionary trust is sometimes called a "family trust" (however, for tax purposes, a "family trust" is defined to mean a trust that has made a "family trust election").

A discretionary trust empowers the Trustee to determine which beneficiaries will receive a distribution of income and/or capital of the Trust. This discretion usually relates to whether income, capital, or a certain type of income or capital, will or may be distributed and to whom.

4. Benefits of a discretionary trust

The benefits of a discretionary trust include the following:

- a high level of asset protection;
- flexibility regarding the distribution of income and capital;
- less regulation than a company;
- the trust deed can be tailored to the needs of principals and beneficiaries; and
- easier to wind up than a company.

One of the main advantages of a discretionary trust is the ability to distribute income and capital tax-effectively. The trustee is able to either distribute income to the beneficiaries or accumulate it (although a trustee may be taxed on accumulated income at the top marginal tax rate). None of the beneficiaries are able to force the trustee to distribute income in a particular way.

The principal benefit of using a trust to carry on a business or hold assets is that no single beneficiary has any claim to any assets of the trust (apart from any unpaid distributions to which they remain entitled) and therefore a trust provides good asset protection.

5. The Docscentre Discretionary Trust

The Docscentre Discretionary Trust Deed has the following features:

(a) It is established by a settlor (i.e. the person or entity who formally settles or creates the trust) usually by the payment of a nominal sum to the Trustee which constitutes the initial trust property. Duty may be payable in some jurisdictions on the creation of a trust.

(b) The trustee has:

  (i) a discretion to allocate income and/or capital to all or any of the beneficiaries, or to accumulate income; and

  (ii) all the powers of a natural person in relation to the trust property.

(c) The beneficiaries consist of several defined classes of persons who may receive capital and/or income. These are:

  (i) Primary Beneficiaries – these are specific named persons selected by you or your adviser;

  (ii) General Beneficiaries – these typically include parents, children and grandchildren, spouses of children and grandchildren and more generally, any company or trust in which any of the beneficiaries have a beneficial interest, and any religious or charitable institutions.

(d) The trust property may be classified as either "income" or "capital" and may be split into a variety of categories.

6. The Trust Term

For legal reasons, a trust must terminate usually within a statutorily defined period of 80 years (except in South Australia and Queensland). This happens on the Vesting Day. The Trust may also be wound up at an earlier date.

7. The Settlor

The settlor should be an independent person or entity who ideally should not be:

(a) a beneficiary;

(b) a trustee; or

(c) an appointor or successor appointor.

The Docscentre Trust Deed prohibits the settlor from holding any of these positions.

The settlor contributes a nominal sum to establish the trust (say, $10.00). The payment of the settlement sum should be recorded in the books of the trust as the initial trust capital.

8. The Trustee

The trustee may be one or more individuals or companies.

The trustee is the legal owner of the trust property, although not the beneficial owner, and is responsible for managing the trust fund. Being the legal owner, all of the transactions of the trust are carried out in the name of the trustee. The trustee signs all documents for and on behalf of the trust i.e. in its capacity as trustee of the trust.

As a trust is not a separate legal entity, the trustee bears the duties and responsibilities in relation to the trust. As such, the trustee is personally liable to creditors and accountable to beneficiaries.

The trustee's overriding duty is to follow the terms of the trust deed. The trustee also has a duty to act in the best interests of the beneficiaries. There are many other duties imposed on the trustee by law including:

- trustees must carry out the terms of the trust;
- trustees must act in good faith;
- trustees must preserve the trust assets;
- trustees must exercise reasonable care in the administration of the trust;
- trustees must not benefit from their position as trustee;
- trustees must not put themselves in a position of conflict;
- trustees must keep proper accounts and records.

The Trustee should preferably be a limited liability company established specifically to be the trustee of the trust. As the trustee is personally liable for the debts and transactions they undertake on behalf of the trust, best practice is to use a company as trustee, for reasons including:

- it is easier and less expensive to change control of the trust;
- a company never dies – this saves the expense of transferring assets to new trustees on a change of trustee or the death or retirement of an existing trustees; and
- it can provide good asset protection, especially if the company has no other significant assets of its own (i.e. if its only role is to act as corporate trustee) which could be exposed to the creditors of the trust.

Note however, that a corporate trustee will not provide total protection. Even with a corporate trustee, there may be circumstances in which a director of a trustee company is personally liable, including:

- taxation offences;
- unpaid taxes or superannuation guarantee;
- taking on debts which the directors know the corporate trustee is unable to repay;
- taking on debts which are not permitted under the trust deed; or
- where the director gives a personal guarantee.

The trustee may be removed and/or replaced by the appointor or may resign by notice to the appointor. If you wish to replace the trustee, a deed of appointment and retirement of the trustee is recommended. We recommend that you contact Docscentre in those circumstances as this must be done in accordance with the terms of the trust deed. Failure to ensure that amendments such as this are properly carried out may have significant adverse consequences.

The powers and discretions conferred upon the Trustee are extensive. We recommend that you read these powers carefully. If you do not understand any of them, please seek professional advice. Note that in the absence of a power in the trust deed to undertake a specific transaction, the Trustee may not legally be entitled to enter into that transaction.

Should different trusts have different trustees?

It is generally preferable to have separate trustees for each trust for the following reasons:

- it avoids the need to prove which assets belong to which trust. If two trusts have the same trustee and one gets into financial difficulty, it could be extremely costly for the trustee to prove which assets are beneficially owned under which trust; and
- there is a risk that a creditor could get access to the assets of all trusts for which the trustee acts i.e. creditors of one trust may access assets of the others.

Trustee's right of indemnity

If a trustee's liability arose from the proper exercise of their powers and duties, the trustee can be indemnified out of trust assets. Broadly, this means the trustee can pay expenses from trust funds, instead of their own, or be reimbursed by the trust if they do personally pay for trust expenses (although, if the assets of the trust fund are insufficient to meet the expenses, the trustee may be personally liable for such expenses).

A trustee can lose their right of indemnity if, for example:

- they do not act within their powers;
- the expense or liability has not been properly incurred;
- the trustee has not acted with reasonably diligence; or
- the trustee has breached their duty.

9. The Beneficiaries

Careful consideration should be given to the trust's primary beneficiaries.

It is generally recommended that you obtain professional advice regarding the identity of the persons in all classes of beneficiaries as this may have important tax, duty and other considerations.

Normally, the Primary Beneficiaries are those persons you wish to specifically name as beneficiaries. The General Beneficiaries include (among others) their parents, children and grandchildren, spouses of children and grandchildren and any company or trust in which any of the beneficiaries have a beneficial interest, and any religious or charitable institutions chosen by the Trustee.

Strictly speaking, a person to whom the trustee can distribute income or capital is only a potential beneficiary and not an actual beneficiary until the trustee exercises the discretion to distribute to that person and actually makes them entitled to income or capital. Until this time, the beneficiary has no rights except to be considered as a potential candidate for a distribution of income or capital.

Nonetheless, in practice, people generally refer to a "potential beneficiary" as a "beneficiary".

The bank account used by the trust should not be used as a personal bank account. This is because adverse tax consequences may arise where beneficiaries draw money for their own use. If money is required from the trust, please contact your accountant before drawing the funds. He or she can then advise you of your tax options in relation to drawing down the funds.

The Docscentre Trust Deed:

(a) allows the Trustee to appoint additional persons as beneficiaries or to remove beneficiaries. Before exercising this power, the Trustee should seek legal and taxation advice particularly regarding the duty and tax implications of that decision;

(b) provides that the Primary Beneficiaries are deemed to have received a distribution of income in default of a determination or allocation by the Trustee in any year. If there are no surviving Primary Beneficiaries or no child of a Primary Beneficiary who is over the age of 18 years alive, any undistributed income is accumulated

(c) provides for the distribution of the capital of the Trust to a specified class of beneficiary if the Trustee does not make an allocation of all the capital of the Trust before the Trust terminates. Among other things, this prevents the Trust property passing to the Settlor should the discretion not be exercised.

10. The Appointor

The Appointor has the power to appoint and remove a Trustee and, therefore, indirectly controls who makes decisions concerning the Trust. The Trust Deed gives the Appointor the power to remove the Trustee and appoint a new Trustee.

If the Appointor dies, becomes incapacitated or bankrupt, or if the Appointor is a company and has a receiver appointed, is wound up or is placed into liquidation, the Appointor is automatically removed. The Trust Deed allows a Successor Appointor to be named who would in those circumstances take over as the Appointor.

If the Appointor dies or becomes incapacitated and has not nominated a Successor Appointor, this power may be exercised by the Appointor's legal personal representatives. In other cases, if there is no Appointor or Successor Appointor, the beneficiaries have the power to appoint a new Appointor.

11. Income Distribution

It is generally desirable to provide for the greatest possible number of potential Beneficiaries. The Trustee may then distribute the income of the Trust most effectively to take into account the relative income levels (and tax rates) of each Beneficiary or class of Beneficiary.

Distributions of Trust income to beneficiaries with lower levels of income may take advantage of lower marginal income tax rates and, in some cases, the tax-free threshold.

It is possible to distribute income or capital to a corporate Beneficiary, taking advantage of the current lower rates of company tax. The use of a corporate Beneficiary is only generally beneficial where the company tax rate is lower than an individual beneficiary's marginal tax rate. A cash flow advantage may also result from distributions to a company, as the timing of the collection of estimated tax in advance of final assessment is significantly later for companies than the tax instalment system for individuals.

When distributing income to a corporate beneficiary, you should seek professional advice regarding the tax outcome of doing so. The operation of taxation rulings (particularly TD 2022/11) need to be considered to ensure that any amount distributed to a corporate beneficiary is not subject to Division 7A of the Income Tax Assessment Act 1936 which regulates loans made by companies to associated parties.

Trust income may be paid to a beneficiary, or allocated or credited to the Beneficiary, as required but in either event, the Beneficiary would be considered to be "presently entitled" for tax purposes.

Particular care must be taken when distributing Trust income to Beneficiaries under 18 years of age. You should seek professional advice regarding the tax rates imposed on minors.

It is important that the trustee holds a meeting (or otherwise resolves) on or before 30 June each year to allocate the income of the trust among the beneficiaries. Please contact your accountant for information on how resoultions should be documented.

12. Income Attribution

The Docscentre Trust Deed includes income attribution provisions.

Generally speaking, this means that the Trust Deed provides that the income of the Trust retains its character as income when it is distributed to the Beneficiaries.

The Docscentre Trust Deed provides that the various types of income specified in the Income Tax Assessment Act 1936 and the Income Tax Assessment Act 1997 may be distributed separately from

the balance of the income of the Trust. These income-streaming provisions are important in relation to dividend income and capital gains and provide enhanced flexibility when using a discretionary Trust.

Due to the application of rules around dividend imputation, it is important to ensure that franked dividends are distributed to individuals who are best able to use any franking credits available. The Docscentre Trust Deed allows the passing through of franked dividends to the Beneficiaries most able to take advantage of them in the most flexible way.

Note that current tax legislation only recognises capital gains and dividend income as being attributable in this way for tax purposes. Other types of income may be "pooled" and lose their character as specific types of income for tax purposes.

13. Default Distributions

Under the current taxation system, any Trust income not distributed to Beneficiaries in a tax year in which it is earned is taxed at the highest personal income tax rate. It is therefore desirable to provide for a default mechanism, whereby any income left undistributed as at 30 June of any given year would automatically be distributed to surviving Primary Beneficiaries or if none survive, their children over 18 years of age.

14. Consider registration for the tax system

There are a number of tax obligations that the trust may have to register for, including GST, PAYG withholding and so on. In this regard, advice should be obtained from your accountant.

15. Personal Services Income

When using a discretionary Trust to carry on a business, it is important that the income of that business is not derived solely from the personal exertion of one or more individuals.

Should this be the case, the Commissioner of Taxation may not accept that the income correctly belongs to the Trust, and may seek to assess the individual personally, negating any benefit in using a Trust.

You should seek professional advice regarding the personal services regime in income tax law if using a Trust where any of the Trust's income is derived from personal services.

16. Asset Protection

Assets held by a Trustee are held for the benefit of all potential Beneficiaries. None of the Beneficiaries of a discretionary Trust have any interest in the Trust's assets. As such, any creditor of a Beneficiary could not gain access to Trust assets to satisfy the personal debts of the Beneficiary. Note however, that the outcome could be different if a Beneficiary became bankrupt and is owed an unpaid entitlement by the Trust.

The Trustee should not incur debts and/or secure debts against the assets of the Trust except where the debts are incurred for the benefit or purposes of the Trust. Used correctly, assets can be isolated from the liabilities of the Beneficiaries and in many cases, the liabilities of the Trustee.

Note however, that the asset protection qualities of the trust are not absolute. For example:

- the Family Court of Australia has a very broad jurisdiction and may make orders which affect trust property in the course of a family breakdown;

- a trustee in bankruptcy may seek to access trust assets for unpaid debts of the trustee or a beneficiary in some circumstances.

Note that the Trustee is personally liable for any debts or liabilities incurred in the course of carrying on the Trust. The Trustee has a right of indemnity from the Trust Property to recoup those liabilities. This

means that a Trustee may be called upon to personally satisfy Trust liabilities if the Trust assets are insufficient to discharge the Trust's liabilities. For that reason, it is generally recommended that the Trustee be a company that has no assets of its own.

17. Estate planning

Since the assets of a trust are not owned by any one beneficiary, the beneficiaries cannot deal with those assets or pass them to their descendants by a will. However, if careful consideration is given to who is and will be the Appointor(s) of the trust, control of the trust may be effectively passed to the next generation.

A benefit of the assets remaining in the trust, under the control of the children but not directly owned by them, is that should the children (or grandchildren or further descendants) encounter financial difficulty or matrimonial trouble, the assets of the trust should hopefully not be available to their creditors or disgruntled ex-spouses for the life of the trust (at least until the assets or funds are distributed to any of those beneficiaries).

In the meantime, if those beneficiaries require funds, assets or anything else from the trust, the trustee still has the discretion to, for example, distribute income or capital to them or make a loan to them.

18. Capital Distribution

The Docscentre Trust Deed permits the Trustee to distribute the whole or a part of the capital to one or more Beneficiaries on or before the Vesting Day. If all the capital is not distributed before the Trust terminates, the Trust Deed provides that it will be distributed to the Primary Beneficiaries and then will cascade to their descendants if there are none alive or in existence. Any distribution of "capital" should be carefully considered and it is recommended that you obtain taxation advice before doing so.

19. Capital Gains

In relation to the distribution of capital gains from a discretionary Trust, it is important to consider whether the potential beneficiaries have capital losses which may be offset against capital gains. It is also important to consider the most tax-effective distribution of the capital gains. You should seek professional advice in relation to those issues.

20. Trust Losses

Losses (whether income or capital in nature) incurred by the Trust cannot be transferred or distributed to any of the Beneficiaries. They are "quarantined" in the Trust and may be carried forward and offset against future gains. If the Trust terminates before the losses can be offset, they are lost.

Please seek professional advice before making distributions to take advantage of Trust losses.

21. Trust Powers

Trustees often have very broad or unlimited powers in deciding on investments. The trustee's powers are set out in the trust deed, but the trustee has a responsibility to exercise skill and care in making investment decisions. The trustee should ensure they take the same degree of care that a prudent person would take in making investment decisions, given their skills and knowledge.

22. Records and Accounts

A Trust is not a taxable entity even though the Trustee must file a tax return each year. In certain circumstances, the Trustee may be assessed and be required to pay tax on the whole or part of the Trust income.

All decisions of the Trustee should be recorded in minutes and the transactions recorded in the books of account of the Trust. The Trustee owes a duty to account to the Beneficiaries.

If the Trustee is a company, it is recommended that the Trustee company's sole activity be to act as Trustee for the Trust. However, if the Trustee carries on more than one function, the distinction between the Trustee acting in its capacity as Trustee, and acting on its own behalf, must always be maintained. Separate books of accounts should be kept for the Trust and the company, and its bank accounts should indicate the capacity in which the Trustee is acting, e.g. the Trust's bank account should be styled "ABC Pty Ltd as trustee for the ABC Discretionary Trust".

It is not necessary for the Trust's accounts to be audited.

The Trust's accounts should indicate whether or not the assets of the Trust are sufficient to meet the liabilities which the Trustee has incurred in that capacity.

23. State Taxes

Depending on the location of Trust assets, duty may be assessed if a change in the beneficial ownership of those assets, or a "resettlement" of the Trust property, occurs. This may occur in several circumstances, including where the Trustee varies the Trust Deed by adding or removing Beneficiaries or, in some states, if a change of trustee occurs. As this can have a significant financial impact, always seek professional advice and assistance before making that decision.

If a Trust asset is transferred to a Beneficiary, the transfer may attract duty on the full unencumbered value of the asset transferred. In some cases, concessional rates of duty may apply. Please see legal advice in relation to those transactions before signing any documents of this nature.