# Discretionary Trusts

## A "Discretionary Trust" is a commonly used structure for holding investments and carrying on small to medium sized businesses.

When used appropriately, a Discretionary Trust offers a number of potential advantages, including:

- "**Asset protection**", meaning that assets held within a Discretionary Trust have a degree of protection from unwarranted claims made against persons associated with the trust. It is possible to use a trust to "obscure" (although not completely hide) the ownership of assets.
- Flexibility with respect to passing investments among family members, and between generations (i.e. "**Estate Planning**"). This is because passing "control" over trust property does not necessarily trigger a transfer of the trust property – avoiding a liability for stamp duty or CGT.
- Flexibility with respect to passing business assets among family members and between generations (i.e. "**Business Succession Planning**").
- The ability to "stream" profits to one or a number of taxpayers from year to year (i.e. "**income splitting**"). The income of the trust can therefore be distributed to persons on lower marginal rates of tax, minimising tax on trust income.
- The ability to "stream" capital gains to one or a number of taxpayers from year to year (i.e. "**capital streaming**").

In summary, an appropriately implemented Discretionary Trust promotes:

- Asset protection benefits;
- Estate and succession planning benefits; and
- Tax efficiency.

## Proper care and consideration

As with all things, the potential benefits of a Discretionary Trust do not come without care and effort. Consideration needs to be given to the following potential disadvantages associated with a Discretionary Trust:

- "Tax losses" that arise in the trust cannot be "distributed" to beneficiaries. Instead, the losses must be carried forward within the trust, and offset against future trust income. The ability to carry forward the tax losses is subject to a number of strict tests. This means that a Discretionary Trust must be used with caution when "negative gearing" is involved, (and consideration should be given to the use of a Leveraged Trust).
- The value of trust assets must be sufficient to justify the expense of setting up and then administering the trust. If the trust earns income or capital gains, financial accounts will need to be prepared and a tax return lodged for the trust.
- Distributions from a trust can impact on a beneficiary's entitlement to receive the old age pension or other social security.
- Administering a trust may require a level of cooperation between family members, who may not share common goals. This can lead to family disharmony, particularly if control over a trust passes to the next generation without appropriate planning.

## The basics of a discretionary trust

A “trust” is not a “legal entity” (such as a company), but is a “legal relationship” between at least two parties: namely, the **Trustee** and a **Beneficiary**. The Trustee holds the “legal” ownership of property and is obliged to hold and use the property for the *benefit* of the Beneficiaries.

A “Discretionary Trust” is one of a number of different trusts. Under a Discretionary Trust the Trustee has the “discretion” to choose among a number of “potential beneficiaries”, who may receive a distribution of profits, capital gains or the original “settled capital”.

The key aspect of a Discretionary Trust is that no particular Beneficiary has a right to any particular income or property of the trust. They merely have the “right to be considered” by the Trustee when the Trustee exercises its discretion.

## How do I set up a discretionary trust?

A Discretionary Trust is established by a **Settlor** giving the Trustee a small sum of money, say $10 (the Settled Sum) to be held for a “class” of potential **Beneficiaries**. The **Settlor** is usually a person who is not related to the Trustee or the intended Beneficiaries, i.e. an accountant, solicitor or financial planner.

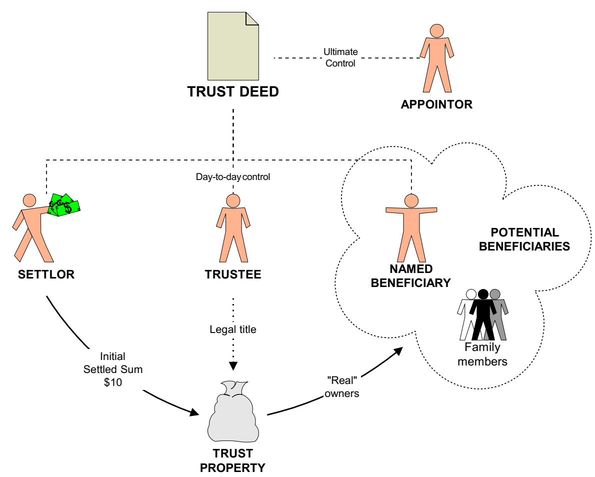
Further **Trust Property** can be added to (or “settled on”) the trust after it has been established.

The **Trustee** is the person who holds the legal title to the trust property, and who therefore controls the trust property from day-to-day. It is possible for a trust to have multiple Trustees. The Trustee can either be a company or an individual. A company Trustee is generally appointed when the trust is going to carry on an “active” business, (rather than holding passive investments).

The “class” of “**Potential Beneficiaries**” is defined with reference to one or more “**Named Beneficiaries**”. The Named Beneficiaries are usually you, your spouse and/or your children. The wider class of “Potential Beneficiaries” is then defined in the Trust Deed to include the Named Beneficiaries, as well as a very wide group of individuals and other legal entities that are in some way related to or associated with the Named Beneficiaries. A Discretionary Trust is often established to benefit members of a particular family, so the Named Beneficiaries include certain family members, and the Potential Beneficiaries are defined to include the wider family and their descendants).

Finally, the Trust Deed usually names an **Appointor**. The Appointor has the power to change the Trustee from time to time. Because the Appointor can change the Trustee – including by appointing themselves as Trustee, the Appointor has **ultimate control** over the trust – and therefore should be chosen with due care. The Appointor can be a company or an individual. It is possible for the role of Appointor to be shared between two or more persons.

The key components of a Discretionary Trust are illustrated below:



## The critical role of the Trust Deed

A Discretionary Trust is established by a written document called a Trust Deed. The Trust Deed regulates all the parties to the trust. It is critical that the Trust Deed be drafted appropriately and takes into account the current and future objectives of the parties involved. Not all Trust Deeds are of equal quality.

It is also critical that the Trust Deed accommodates estate and succession planning objectives from the outset. Although it is possible to amend a Trust Deed, this must be done very carefully, to avoid unintended CGT and stamp duty consequences.

## What next?

If you already have a Discretionary Trust, then it is important that you have the Trust Deed reviewed periodically, to ensure that the Trust Deed adequately deals with any changes to our taxation laws, and continues to appropriately facilitate your estate and succession planning objectives.

If you would like to speak to someone about reviewing and updating your Trust Deed, call us on 1300 654 590 or email us at wehelp@adlvlaw.com.au.

Further information can also be found on our website at www.adlvlaw.com.au.