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## **Trust Deeds for Accountants**

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## TRUST DEEDS FOR ACCOUNTANTS

*“Just as the surgeon needs a sharp scalpel to perform an operation, so too the accountant should be provided with a precision instrument to fulfil his or her professional function”*

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Perth

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### WHAT IS A DISCRETIONARY FAMILY TRUST?

Trusts generally fall into two main categories, namely

1. Express trusts: that is, trusts arising from express declaration, which can be effected by some agreement or common intention held by the parties to the trust. Trusts for valid charitable purposes are usually express trusts.

2. Trusts arising by operation of law; which might be either:

(a) Resulting trusts: which may arise from a failure to dispose of the entire beneficial interest in property under a settlement or other instrument creating a trust, or upon the purchase of property by one person in the name of another where there was no intention to make a gift; or,

(b) Constructive trusts: trusts imposed by the court irrespective of the intentions of the parties in circumstances where it would be unconscionable for the legal titleholder to deny the beneficial interest claimed by another party.

A “Family Trust” is an express trust established for the benefit of members of a family. The most common form of family trust is the discretionary trust, created by a deed between a **settlor** and a **trustee**, with general and default beneficiaries and discretionary powers reserved to the **trustee**.

### ***Who needs a Discretionary Family Trust?***

Family trusts provide family groups with a great deal of scope in sharing the tax burden among the family and protecting family assets. Therefore, any family group with either capital growth or income-generating assets needs a Family Trust structure. However, in order to serve its purpose effectively, the Family Trust should be maintained and reviewed regularly.

### ***What is a Family Trust good for?***

The family trust has many valuable attributes. It provides some protection from bankruptcy and insolvency; it is a relatively low cost and simple business structure to use. It is also an excellent vehicle for estate planning issues such as avoiding the challenging of Wills. A second and less important benefit is the discretionary manner in which income can be distributed

Trusts still have more family and commercial flexibility than other types of structures.

Trusts are generally cheaper to run

### ***Asset protection***

1. Assets held in a discretionary trust are neither available to the creditors of the principal behind the trust, nor to the creditors of any discretionary beneficiary. Beneficiaries’ interests under the trust deed do not vest in the trustee in bankruptcy
2. It is possible to use an anti-bankruptcy trigger to strip power of appointment from a bankrupt.
3. The use of corporate trustee with full right of indemnity against trust assets avoids putting personal assets at risk
4. May be “effective” for family law purposes – S90(b),(c) and (d) –especially when used with **Binding Financial Agreements**

5. Can reduce legal risk by holding passive income generating assets (property) in a separate trust from active income producing assets (business)
6. May be able to vest assets from a discretionary trust for a nominal stamp duty, but potential CGT consequences
7. May be used for **estate planning** purposes. Family trusts allow legal avoidance of *de facto* death taxes because case law has held that the rights of beneficiaries in Family Trusts don't constitute an "interest" in their Will. Interestingly, the assets of a family trust do not form part of a deceased estate. A person could have millions in their Family Trust and yet die a pauper.
8. The only exception to this is "Loan Accounts". These are moneys that someone has "loaned" to the Family Trust. These balances belong to the person making the loan.

### ***Tax advantages***

Flexibility in distributing income and vesting assets in beneficiaries taking into account the tax profile of the recipient. For example –

1. up to \$6000 per annum can be given to a son or daughter over 18 with no other income (eg a university student) totally tax free;
2. distribute "excess" income to a corporate beneficiary, capping family tax rates at 30%;

Trusts still retain their flow through treatment of income/capital gains derived.

Division 115 discount. Where the relevant capital gain is distributed to taxpayers eligible for the general discount, a flow-through is available.

Division 152 concessions. These may flow through to beneficiaries.

### ***How does a Family Trust work?***

The Family Trust is generally operated by the person responsible for preparation of the annual accounts on behalf of the trustee. Once the income and expenditure, assets and liabilities of the Trust are known at the end of the financial year, the accountant advises

the trustee who then exercises its discretion to distribute the income or capital of the trust in the most effective manner.

The decisions of the trustee are recorded in a minute book as resolutions. All other significant acts by the trustee should also be minuted.

### ***How do you set up a Family Trust – who are the main players?***

To create a family trust, you need the following people:

1. The person who starts the trust off - **settlor**
2. the legal (in name only) owner - **trustee**
3. the person who hires and fires the trustee - **appointor or guardian**
4. the group of people who can benefit - **beneficiaries**

The trust is created by the **settlor** giving the **trust fund** (business or other assets, such as a home) to the trustee upon trust for the beneficiaries.

### ***The Settlor***

Certainty of intention to create a trust requires that the trust fund be 'settled' on the trustee by the settlor

In order to create a valid trust by way of a settlement *inter vivos* it is necessary that the settlor display a sufficiently certain intention to do so. While no magic words are absolutely necessary, in professionally drawn deeds it is prudent to use words clearly indicating that intention such as 'To hold upon trust for' and the like.

If words displaying such an intention are used, but the tenor of the whole instrument is such that no trust is intended, the supposed trust may fail for want of sufficient certainty of intention to create a trust. Where, for instance, a settlor transfers property to a nominated trustee upon trust in accordance with the terms of a deed but the terms of the deed are such that the settlor can, by his own actions, recover all the property of the trust, or prevent the trustee from making any distribution in favour of the nominal beneficiaries, the trust may be held to lack the necessary certainty of intention.

### ***Who can be the Settlor of the Family Trust?***

The settlor should be an independent but trusted party who starts the trust by putting an asset into it (usually \$10). After the Family Trust is set up, you transfer assets or funds to purchase assets into the trust. A settlor should never be a beneficiary or a member of a class of beneficiaries - S102(1) ITAA36.

It is prudent not to make the settlor of a trust the appointor, particularly if the trust is a discretionary trust in which the trustee has power to add beneficiaries without exception. The settlor could then, as appointor, appoint him or herself as trustee, add him or herself as a potential beneficiary and then, assuming the trust is a discretionary trust in which the trustee can distribute all the trust property to one beneficiary to the exclusion of all others, resolve to distribute all the trust property to him or herself.

The settlor should, once the trust has been settled, bow out and have nothing further to do with it.

### ***Who can be the Trustee of the Family Trust?***

Everything is in the trustee's name, but only as the legal owner. Not the "beneficial" owner. The trustee is owner in name only. The trustee can be you and your spouse, just you or your company

In the old days the Trustee of the Family Trust would be Dad or a company. These days the Trustees are generally Mum and Dad. Where there are two or more trustees their decision has to be unanimous (otherwise the Trust Deed needs amending). If the Ralph amendments ever get through it will continue to be the case that it is generally a waste of money to have a company as a Trustee.

### ***Who should be Beneficiaries of a Family Trust?***

None of the beneficiaries can demand anything from the Family Trust. It is the Trustee (acting under the advice of the Appointor) who decides who gets what. Therefore, your class of beneficiaries should be as wide as possible.

Beneficiaries have no rights to demand any asset under a Family Trust. They have no property in the Family Trust. They only have a right to be considered –a "mere hope" that they may get some income or capital from the Family Trust

The beneficiaries are usually divided into 2 classes, namely:

1. General Beneficiaries: these parties receive income and capital from the trust only as the trustee directs; and
2. Default Beneficiaries: these parties get the income if the trustee fails to make a direction

It is proposed by the *Entities Tax Bill* that any income retained within the Family Trust is taxed at the corporate rate of 30%. Any Family Trust deed you contemplate should therefore contain the power to accumulate income and not distribute to the default beneficiaries

### ***Who should be the Appointor and Guardian***

The appointor is the person who ultimately controls the Family Trust. The power to appoint and dismiss the trustee is given to the appointor (sometimes called Guardian) of the trust. Usually the trust deed confers this power on one or two people. You can also appoint both yourself and your spouse as joint and several appointors.

Attention should be given to the chain of succession of appointorship. An appointor can *inter alia* appoint more and other appointors. This can be done by deed or Will, although the latter is more open to challenge.

### ***The Trust Deed***

The trust deed is the Constitution of a voluntary trust. For a voluntary trust to be enforceable at the suit of the beneficiaries it must be completely constituted.

To be 'completely constituted' a trust must display a sufficiently certain statement of intention on the part of the person creating the trust (**settlor**) to do so, in writing if required by statute. The trust property, which must also be sufficiently certain, must be vested in the trustee.

The trustee must have accepted the trust so that he or she is thereby bound by the trust and the beneficiaries or objects of the trusts must be identified with sufficient certainty so that the trust is administratively workable. Express voluntary trusts are invariably created by express declaration of trust or by transfer of the trust property to the intended trustee.

An express trust may also be created by the transfer of certain property to a trustee to hold on trust. This may be affected either by settlement *inter vivos* or by will. This paper

is not concerned with wills but, apart from the requirements for the formal validity of a will, the principles for the creation of a valid trust are the same for testamentary and non-testamentary settlements.

Upon the creation of any trust the trust property must be vested in the trustee. Where the trust is created by express declaration then the property must, by necessary implication, be vested in the trustee. If it is not the declaration will be ineffective.

Where a trust is created *inter vivos* by transferring property to trustees, for the trust to be completely constituted, the trust property must be vested in the trustees at the time the trust is expressed to come into operation, although it is common for a trust to be established by the settlement of a nominal sum, say \$10, on the trustee at the outset while the other assets of the trust are transferred thereafter by way of voluntary transfer or, more usually, by way of purchase, with the necessary funds being loaned to the trust for the purpose. The method chosen will usually be determined by the stamp duty and any other transfer tax implications at the time.

Where new trustees are appointed, whether by a nominated appointor or by the court, and for whatever reason, it will be necessary to vest the trust property in the incoming trustee or trustees. This matter is provided for in legislation, which is substantially the same in the various States, the only difference being that in Victoria, Queensland and Western Australia there is no provision for vesting upon the retirement of a trustee because those States require the necessary conveyances to be effected before retirement

In the case of property which does not require such formalities as registration or notification to be validly transferred at law the deed of appointment of the new trustee may also act as the conveyance of the legal title in those assets. However, where registration or some other procedure is required by law it will be necessary to complete those steps before the trust property can vest in the incoming trustee. The court also has the power to make vesting orders where it is necessary to do so, as may be the case where the person in whom the trust property is presently vested is incapable of making a valid assignment. There are a number of grounds specified in the trustee legislation of the various States for making such an order.

There may be circumstances in which those creating a trust will want to build into it some mechanism for unravelling it should a change in circumstances warrant the winding up of the trust. The inclusion of some such device is sensible. But one should be careful in

drafting any such provision to avoid negating the essence of the trust. This is the intention to hold the property (subject to the trust) upon trust for the objects of the trust. A proviso that neither the settlor nor the appointor can be added to any list of beneficiaries is a useful means of protecting the trust from such a contingency. Again, regard should also be had to the wording of 102 ITAA36.

### **The Vesting Date**

It has long been the policy of the courts to prevent property being tied up for inordinately long periods of time. This is not a policy against perpetual ownership. If it was, it would not be possible to settle property on trust for a corporation which is, by its nature, perpetual.

The evils which are sought to be avoided are restraints on alienation for an unduly long time and remoteness of vesting. If property is settled upon successive life tenants for several generations there will not be anyone, until the expiry of all those generations, who will be free to alienate the entire estate in the property subject to the gift.

Not only that but, down the chain, interests will vest in favour of, say, the first grantee's grandson or great-grandson, at some remote time in the future. The judicial response to these concerns, and to the practice of conveyancers in the centuries after the *Statute of Uses 1535* had made it possible to create future estates at law by settling property on a seemingly endless chain of successive life estates, was to develop rules prohibiting the limitation of estates beyond a certain time, the so-called rule against perpetuities, which is really a rule against remoteness of vesting.

The limitation of future estates is no longer a feature of conveyancing practice. The rule against perpetuities continues to be of relevance to those drafting trust deeds, particularly in those States which have not enacted any statutory reform of the common law rule, because it is a rule which, in those jurisdictions at least, can render a trust void *ab initio* where the settlor purports to settle property on trust for the benefit of some who might take a vested interest in the trust property outside the allowed period.

### ***How much stamp duty is paid on a Family Trust?***

Stamp duty is calculated on the original money settled. Usually \$10 is given to the trustee by the Settlor. The current stamp duty on \$10 is \$1.95 (for WA). (Each copy of the Family Trust is an additional \$1.95.) You usually get 2 copies of a Family Trust deed: one for the professional adviser and one for the client.

**A note about Part 11BAA**

Under certain circumstances, a full or partial exemption from stamp duty is available on the transfer of farming property between family members or by a natural person to a discretionary trustee of a discretionary trust, subject to the satisfaction of certain conditions. They are:

1. The exemption applies to transfers by way of sale or gift.
2. Transfers of other property which forms an integral part of the farming operation, but which are transferred separately from the land (eg milk quotas, egg licences etc.) are also eligible for the exemption.
3. An exemption is also available for the transfer to a family member of an interest in a farming partnership or a share in a farming company where the partnership or company includes property other than farming property. The exemption is limited to the extent of the farming property.
4. Conveyances to a de facto spouse of the transferor are not eligible for exemption.
5. Transfers of motor vehicle licences to family members are not eligible for exemption under this Part.
6. An exemption or refund is not applicable if in the preceding 5 years, the transferor received an exemption under this Part on the instrument whereby the property was acquired.
7. The conveyance of property to a unit trust or a company which is not a trustee of a discretionary trust is not eligible exempt for an exemption under this Part.
8. Conveyances made by a transferor to a combination of an eligible transferee and a non-eligible transferee are not eligible for an exemption.
9. Conveyances made by a transferor to a combination of a family member or a trustee for a family member or a discretionary trust are eligible for an exemption.
10. The conveyance of farming property to a discretionary trust is eligible for an exemption where the application satisfies the following criteria:
  - a. the transferor must be a natural person;

- b. the transferor must not occupy a position of control of the discretionary trust;
  - c. all of the persons who have a share or interest in the discretionary trust property (including all of the designated beneficiaries of the discretionary trust) must be family members of the transferor; and
  - d. the discretionary trustee intends to continue to use the farming property in the business of primary production.
11. Section 75HA of the *Stamp Act* empowers the Commissioner to assess stamp duty in circumstances where an interest in a farming property, a farming partnership or a farming company was transferred to a discretionary trustee and was exempted from duty under this Part and where, during the life of the transferor, a taxable event occurs and a non-entitled person, being a corporation or a person who is not a family member:
- a. becomes entitled to a share or interest in the trust property of the discretionary trust, whether that share is vested or contingent; or
  - b. otherwise benefits from the family trust; or
  - c. the relevant transferor gains control of the discretionary trust.
12. A person who contravenes subsection 75HA(3) by failing to lodge the prescribed statement with the Commissioner or lodges one which is false in any material particular commits an offence.
13. Applications for exemption from stamp duty under this Part should be made at the time of lodgement of the instrument. Where duty has been paid on the instrument to which the application relates, an application for a refund must be accompanied by the original of the stamped instrument of acquisition and must be made within 12 months of the day on which the instrument was stamped.

### ***What happens if the Family Trust goes broke?***

The trustee of the trust is indemnified out of the assets of the trust. The beneficiaries of a trust are likewise personally indemnified. This means that should the family business find itself in difficulty with creditors and the Trustee has signed no personal guarantees then it is possible that the only assets that can be called upon to pay these debts are those owned by the Family Trust.

The trust can also limit the personal liabilities of individual members of the trust's business. Properly set up, the business is not owned by the individuals, as in the case of a partnership; the business is owned by the trust for the benefit of its beneficiaries.

Personal assets owned by the Trustee outside the trust are generally not available for discharging any business liabilities. A director generally goes down with the company. However, the Trustee, Appointor and Beneficiary generally don't go down with a Family Trust

## **Using the Family Trust**

### ***Income streaming***

The trust deed should make specific provision for the streaming of income (as opposed to capital) to beneficiaries. This is to take account of a 1992 attack on family trusts by the Commissioner of Taxation.

"Streaming provisions" allow you the trustee to distribute one type of income to one person and another type of income to someone else. The income is distributed with reference to its source. For example, you may want to distribute dividends with franked credits to a high income earning beneficiary. Similarly you may want to distribute income subject to capital gains tax to a lower income earner.

### ***Accumulation***

In addition the trust deed should include the power to accumulate income in line with the proposed *Entity Tax Bill* changes to the taxation of non-fixed trusts.

All trust deeds should be reviewed from time to time to make sure they are still up to date. If family circumstances change (for example, if parents divorce) they should review all trust documents immediately.

### ***A note about Resettlement***

As will be discussed more fully in another paper, when drafting a trust deed, particularly the beneficiary provisions, care should be taken to choose words which are not likely to cause a resettlement issue to arise further down the track. For example, the appointor or the trustee should not be included by title as a beneficiary since the person holding that title may change from time to time giving rise to a resettlement with adverse Capital Gains Tax and Stamp Duty consequences.

Similarly, when reviewing a trust deed, care should be taken not to interfere with classes of beneficiaries for the same reason.

### ***Current Courts attitude to Family Trusts***

Twenty years ago the Family Law Court snubbed its nose at Family Trusts and said they would treat the assets as forming part of the 'asset pool', to be divided between the parties. This is still the case today, although the Courts interference can now be avoided by use of a Binding Financial Agreement.

Today, Centrelink is doing the same thing with regard to Social Security recipients. New legislation allows it to "look through" to the real controllers of the Family Trusts. This having the force of statute law, the Courts would be hard pressed to deal with inequities which may arise.

Apart from these, on the whole, the Courts are likely to continue to respect a genuine Family Trust structure where there is no tax avoidance scheme involved.

### ***Current ATO position***

The ATO and Treasury hate Family Trusts. That is evident from the whole tenor of 'A New Tax System' ('ANTS'), which is supposed to be so good it will render old-fashioned anti-avoidance provisions like Part IVA obsolete.

Two aspects of ANTS which specifically target Family Trusts are the *Entities Tax* and the *Alienation of PSI* provisions.

### ***Entities Tax***

This regime was originally scheduled to come into effect on 1 July 2001, however vigorous political lobbying saw it relegated to the 'back burner' for the time being. Most pundits now say it is only a matter of time before the regime comes back, albeit in a slightly altered form.

Family Trusts are arguably still a useful vehicle if the *Entities Tax Bill* goes ahead.

The proposed legislation has Family Trusts taxed at the same rate as companies - 30%. This applies to income whether "distributed" or "accumulated". You "distribute" if you pay out income to the beneficiary. You "accumulate" if the Family Trust just keeps the money and pays the taxman 30% on the profits. Beneficiaries are entitled to the 30% "franking credit" for tax paid by the Family Trust in the year they get the income.

["Franking credit" applies for example if the trust "accumulates" the income then it pays tax on that income at 30%. For example, \$1,000 income means \$300 in tax in that year. You don't "lose" that \$300 that you paid in tax. Next year you distribute "last years

\$1,000” to John Jr your son. If John Jr earns only a small income then he gets back all of the \$300 that the Family Trust paid in tax.]

### ***Alienation of PSI***

One important leg of ANTS is the Alienation of Personal Services Income ('APSI') provisions. Those provisions are founded on the fictional pretext that where PSI is concerned, there are really only two kinds of taxpayers, namely employers and employees, so that everyone has to be slotted into one category or another. This makes it much easier to collect tax. That is what the 'tests' are designed to do.

One of these is the '80% rule'. If 80% or more of the income is from one client, you fail, you're an employee not an employer. If you pass, you still have to face one or other of the 'unrelated clients' test, the 'employment' test or the 'business premises' test.

The 'unrelated clients' test requires the taxpayer to have personal services income from two or more clients who are not associated with each other or with the individual doing the personal services work if the taxpayer is a “personal services entity”. The clients must also come from direct advertising or word of mouth, not an agency.

The 'employment' test requires the taxpayer to "have employees or engage sub-contractors or entities who perform at least 20% (by market value) of the principal work" or "apprentices for at least half the income year". You can count related persons who perform principal work but you can't count companies, partnerships or trusts associated with you. If you operate through a personal services entity, not surprisingly, you can't count yourself as an employee for this test.

This has caused considerable consternation in the business sector. Many in the financial advising industry for example, while they had long considered themselves employers, were finding themselves uncomfortably on the borderline of the 80% rule and the 'unrelated clients' test, among others.

In the period leading up to the November 2001 Federal Election, a number of industry groups lobbied long and hard to be able to decide for themselves how to proceed until such time as all the facts were on the table and the law could be applied fairly and equitably. Politics being what they are, they won that battle. At least for the time being

### ***Current Centrelink attitude***

The *Entities Tax Bill* aims to make all business vehicles equal. The new social security means test rules seek to ensure that however you hold your assets you receive comparable treatment. If you hold assets in a company, Testamentary Trust, Family Trust or fixed trust you should be treated the same as though you held those assets in your own name (beneficially).

The new rules start 1 January 2002. (This gives us time to take stock of our position.)

1. They affect both existing and “future private trusts” and “private companies”.
2. They don’t affect “public unit trusts”, “public companies”, “wealthy companies” and “Superannuation” (including Self Managed Superannuation).

### ***The Control Test***

You control the trust if you can:

1. Dismiss and appoint the Trustee
2. Veto a trustee’s decision
3. Amend the Trust Deed
4. Have an “associate” controlling the trust and you “informally control” the “associate”

There is little recognition on who has the day-to-day management issues of the vehicle. Centrelink is seeking out the ultimate controller. Generally the appointor, principal and guardian hold this position of power. The trustee of a trust may also hold some of these powers.

If you are the controller then you suffer “attribution”. The income is therefore attributed to you.

### ***A note about “informal” control of a Family Trust***

The fourth category of control is “informal” control. Attribution is made to a person who has control via an associate.

“Associate” includes your:

1. spouse (including defacto but not mistresses?);
2. parents, grandparents;
3. children and their spouses, and the children of those children and their spouses;
4. siblings and their spouses;
5. nephews and nieces and their spouses;
6. uncles, aunts and their spouses, and the children of those parties and the spouses of those children;
7. professional adviser e.g. an accountant, solicitor or financial adviser who may be expected to act in accordance with the person’s wishes.
8. a trustee of a trust from which the person can benefit, either directly or indirectly;
9. a partner of the person or a partnership in which the person is a partner;  
and
10. a company where:
  11. the directors could reasonably be expected to act in accordance with the directions or wishes of the person; or
  12. the person and associates can cast more than 50% of the votes at a general meeting of the company;
13. A specified class of persons who, in the opinion of the Secretary, should be treated as an associate of the person.

### **Source Test – Gifting assets into Family Trusts**

We have looked at control of the family trust. Now we need to deal with gifting assets into the trust. These rules only apply where gifted the asset or service was gifted into the trust after 7.30pm WST on 9 May 2000.

The big assumption:

If you gift an asset to the trust then you retain some control of it. Therefore under the source test you are a controller.

Can you get around the rules by:

1. transferring assets into the trust for “inadequate” consideration?
2. transferring assets “indirectly”?
3. giving “services” instead of “assets”? (i.e. work for free)

The answer is no for all of the above.

### **“Genuine Gift” Exemption**

If you did give the asset away but truly don’t “control” the trust or company?

The source test is not absolute. There is compassion. Just because you transferred assets to the company or trust doesn’t automatically trigger the attribution. You need to look at the facts on a case-by-case basis. The question of control is only one factor to be considered. If you can clearly show that:

1. a genuine gift has been made
2. you have no ongoing involvement in the trust or the company at all

then you don’t suffer attribution under the source test. (You still suffer the deprivation rules.)

Example

John puts \$250,000 rental property in a trust (after 9 May 2001). His son is the appointor. His son does what ever his dad asks (like all good children). John can rely on his son.

1. Under the source test is John attributed with the trust assets and income?
2. Would John be deemed the “controller” of the trust via an “associate”?

***When do the “Gifting Rules” apply?***

When you actually gift assets to the trust or company is important. Centrelink is kind. It doesn't want you to suffer both the Deprivation (5 year gifting rule) and Attribution (control test). Therefore -

1. If you made the gift before 1 January 1997 – no change. This is because Deprivation is only for 5 years anyway. Five years will be up by 1 January 2001. However, the above Attribution rules still apply if you still remain in “control” of the trust or company.
2. If you made the gift between 1 January 1997 and 31 December 2001 – If Attribution (still in control) applies to the trust or company then Deprivation ceases. (This is even though the 5-year Deprivation period is not yet expired.) If you don't have “control” of the Trust or Company then Attribution won't apply. The Deprivation assessment continues for the full 5 years.
3. If you make the gift on or after 1 January 2002 – If you are in control then Attribution applies and no gift is taken to have occurred - no Deprivation. However you may have made the gift but not stayed in control. Therefore there is no Attribution. Instead you suffer the 5-year Deprivation gifting rule.

***Tax Disadvantages***

The Trust Loss provisions have made it increasingly difficult to access tax losses. There is a loss of flexibility as a result of a family trust election and the potential application of Family Trust Distribution Tax

It can also be more difficult to access Div 152 concessions than if assets held in personal capacity.

There are also potential “deemed dividends” where unfounded distribution has been made to a corporate beneficiary and then beneficiaries create a debit loan account within the trust – S109UB ITAA36

### **Loan Accounts**

It is common practice, in relation to family discretionary trusts, for the principal of the trust, who is usually the main income earner or controller, to use the marginal tax rates of his or her family, or perhaps a corporate beneficiary, to produce the lowest net tax position possible. Nevertheless, that person and therefore the trustee, does not actually want to lose the benefit of the use of the money and instead credits those distributions to particular beneficiaries’ loan accounts. A family trust is useful in soaking up low tax rate thresholds that would otherwise be wasted.

It is a common practice for accountants to credit unpaid income distributions to beneficiary loan accounts, despite ample case law authorities and trust deed provisions to the contrary. As we will explain, this treatment is generally incorrect and fails to recognise the essential differences between a trust entitlement and a loan.

A loan arises when money has been advanced on certain terms and conditions, including the requirement for repayment at some point in time. While the trust deed may define an amount as having been “set aside” when it is credited to the beneficiary in the trust’s books of account, this does not mean that it should be credited to a loan account.

Once the trustee has exercised its discretion and made the decision as to how the net income of the trust is to be distributed, the beneficiary becomes beneficially entitled to a share of that net income. Until the share is paid, the beneficiary has an equitable claim against the trustee for immediate payment of the unpaid share.<sup>1</sup>

The unpaid share should be described in the trustee’s books of account as an “Unpaid Beneficiary Entitlement” or words to that effect. It is not a loan because no money has changed hands and no obligation to repay has arisen. If it is misdescribed as a loan, this does not alter its essential character as an unpaid distribution.<sup>2</sup>

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<sup>1</sup> *FCT v Whiting* (1943) 68 CLR 199

<sup>2</sup> *Eurasian Holdings Pty Ltd v Ron Diamond Plumbing Pty Ltd* (1996) 14 ACLC 502; *CIR (NZ) v Ward* 69 ATC 6050

There are 5 important characteristics of unpaid distributions. They are:

1. the beneficiary's entitlement is enforceable in equity rather than at common law. This means that the range of remedies is wider and includes tracing of the equitable interest into other funds or trust property;
2. the trustee has a fiduciary duty to protect the beneficiary's entitlement. This is a much more onerous duty than that owed to mere creditors;
3. there is no limitation period on the recovery of trust property or the proceeds thereof from a trustee, whereas there is generally a 6 year statutory limitation period on the recovery of debts;
4. the beneficiary would probably be absolutely entitled to any income generated by an unpaid distribution, especially if it constitutes a separate trust fund; and
5. the unpaid distribution may no longer form part of the source trust fund but it is held by the trustee for the benefit of the beneficiary entitled to the distribution.

These characteristics have implications in trust law as well as tax law. For instance, if the trustee of the source trust became insolvent, it is arguable that part of the assets of the source trust are not available to creditors because they actually represent unpaid entitlements held in trust for beneficiaries of the source trust.

This situation could give rise to an accounting nightmare if the unpaid income is simply re-invested in the source trust. That is, if the trustee decides unilaterally that it will distribute a certain sum to a particular beneficiary by way of crediting to that beneficiary's loan account. In many instances, the beneficiary does not even know that any such event has occurred and the principal's accountant merely obtains the beneficiary's signature on the relevant tax returns.

The situation may become even more unpleasant if there is a family falling-out or a death of the principal. A particular beneficiary may demand, as of right, the amount of the loan account since he or she is absolutely entitled to that amount

### ***Tax Implications***

As to the proper tax treatment of earnings on the unpaid distributions, if they give rise to nothing more than an equitable right to demand immediate payment of unpaid income,

then it is arguable that until that right is exercised, no income accrues to the beneficiary in relation to such earnings.<sup>3</sup> If however the trust deed specifically provides that a separate trust fund arises for the beneficiary when the income distribution accrues, then the beneficiary entitled to the income distribution should also be entitled to any income earned from the investment of that separate trust fund.

This is the case whether or not the beneficiary is a 'resident' under Australian tax law. Of course, if the beneficiary is a non-resident and pays tax elsewhere, the amount payable in Australia would be subject to any applicable Double Tax Agreement.

### ***Documentary Evidence***

To ensure that the trustee can retain those amounts, at the time of distribution there should be an agreement (evidenced by *inter alia* an actual crossing of cheques) that the money is to be loaned back at no interest for a specific period. If there is no such documentary evidence, it appears that the amount is still characterised as a distribution to a beneficiary rather than a loan made to the trust by a person who coincidentally is a beneficiary.<sup>4</sup>

Where the beneficiary decides to forego its entitlement to the amount in question, whether for Centrelink or other purposes, if there is no formal loan agreement and the amount remains classified as unpaid distribution, the amount should first be distributed out and brought back in the accounts of the trust as a loan or a gift. If there is a loan agreement in place, the loan can simply be forgiven, that is the loan amount is gifted to the trust.

### ***Stamp Duty***

Stamp duty is payable under section 16 of the *Stamp Act 1921* (WA) on loan agreements. The current rate for an amount over \$35,000.00 is 0.4%. If the loan agreement is not in writing, the duty is still payable under section 31B (1)(c).

If a gift is made by way of deed or 'instrument', *ad valorem* duty is payable on the deed. Where there is a gift of cash not made by deed, no duty is payable. Therefore, such a gift

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<sup>3</sup> per Kitto J in *Taylor v FCT* 70 ATC 4026 at 4030

<sup>4</sup> *Re Associated Electronic Services Pty Ltd* [1965] Qd R 36

would be better recorded by way of a statement in trust minutes rather than an Acknowledgement of Gift.

***Conclusion - How do I keep my Family Trust in good fettle?***

Family Trusts provide great flexibility and less governmental interference than companies. You also get asset protection, income streaming, a fixed tax rate and are not subject to Will challenges. Wealth in your Family Trust doesn't "belong" to you (you just "control" it.) Therefore your Will can't touch or effect those assets.

The Family Court often sees fit to ignore a Family Trust. However, a spouse can have a Prenuptial Agreement (officially called a "Binding Financial Agreement"). The Family Court has to follow a legal Binding Financial Agreement. Binding Financial Agreements only became part of Family Law in December 2000.

Centrelink proceeds on the basis that anyone who has income-producing assets or money in the bank, whether in their own name or via a trust, does not deserve a pension. This gives rise to enormous social inequities and can defeat the purpose of the Family Trust.

Loan accounts can be ignored for only so long before they become a real issue in the smooth operation of a trust

All of these things can be addressed by regular and thorough 'servicing' of the Family Trust by the tax lawyer, in conjunction with the accountant. We recommend that this be done every year if possible – at least every 2-3 years.