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Question 6: Business Succession Planning for STEP 4 October 2019 Submission Session

(Completion Date: 25 September 2019)

1 This essay responds to question 6 in the STEP 2019 topic list, which requires a discussion about business succession planning in the context of discretionary family trust.

2 My response addresses the 3 elements of the question:

i. the elements that should be considered in the trust deed, so as to shelter any trustee liability in the conduction of the operating business

ii. the factors that the trustee should consider during the trust administration about the underlying operating business

iii. the reason why a trust, in the form of a discretionary trust, could be a valid succession planning tool from an Australian tax law perspective.

Features of a discretionary trust by reference to the Australian tax law

3 The most relevant form of trust in relation to the topic question is a discretionary trust. Under common law, a discretionary trust is a trust in which the trustee has a discretion as to when any payment from a trust will be made, who in a definite class of beneficiaries will receive it, and the amount of such payment.

4 The main features of a typical family discretionary trust (as opposed to fixed trusts, child maintenance trusts, unit trusts or superannuation trusts) are as follows:

i. The trustee - which is usually a shelf company controlled by the client (for example in this case, the parents of the family, Mr and Mrs Sydney, who contributed the bulk of the trust estate), but may be a trusted friend, or a family member of the client- is given wide discretionary powers in relation to the distribution of income and the appointment of capital among members of the Sydney family. The trustee should have the discretion to distribute different categories of income to different beneficiaries, and to treat as trust income, capital gains or receipts deemed to be income for tax purposes, otherwise the tax advantages of a family trust will be reduced.

ii. A clause in the trust deed will give the client the power to remove any trustee, and to appoint a new trustee or trustees, thereby giving the client indirect control.

iii. The trustee is given wide power to acquire, deal with or dispose of property (personal property and real property), to carry on business, and to make loans.

iv. Discretionary family trusts provide a mechanism to pass family assets to future generations, and can provide a means of accessing favourable taxation treatment by ensuring all family members use their income tax “tax-free thresholds”.

v. Division 6 of the Australian Income Tax Assessment Act 1936 (“*ITAA36”)* is considered to be the exclusive code for the assessment of a trustee (and a beneficiary) in respect of the income of a trust. Trustees of trust estates are generally only taxed on trust income under Division 6 of the *ITAA36* where a beneficiary is not presently entitled, or is presently entitled but under a legal disability. In all other circumstances the beneficiary is taxed. This taxation of the beneficiary rather than the trustee is commonly referred to as “flow-through” taxation, which can give tax advantages to low-income family members who are also beneficiaries of the trust.

vi. Capital gains and franked distribution can be streamed to beneficiaries, which can provide tax planning opportunities, in such a way that the trustee can stream capital gain to a particular beneficiary who has a capital loss, and stream franked dividends to potential beneficiaries. Additionally, electing to be a family trust can restrict and specify the trust beneficiaries, which in turn can secure or simplify the claiming of tax losses, debt deductions, franking credits and abrogate certain trust beneficiary reporting rules. ("Streaming" and "family trust elections" are governed by specific statutory rules which are beyond the scope of this submission.)

vii. Special rules apply in calculating the tax payable on income of a minor (*Pt III Div 6AA; s 102AA to s102 AGA ITAA36).* These rules were introduced to discourage income splitting by diverting income to children, but they are not limited to situations where income splitting is involved. Under these rules, "unearned income" of minors over a certain level is taxed at the highest marginal rate of tax (45% for 2018-2019). The rules apply to income, including capital gains, derived by the minor directly or through a trust. Where the minor is a resident, the special rules do not apply if the relevant income is $416. The low income earners rebate is no longer available for the unearned income of minors. (*Para 2-160, Australian Master Tax Guide, Wolters Kluwer 64th edition 2019).*

5 These features of discretionary trusts mean that trustees should therefore take care in relation to which beneficiaries are chosen to receive distributions, as a penalty tax rate can apply to undistributed income of the trust fund, or distributions made to minors.

6 A discretionary family trust can assist in protecting the family group's assets from the liabilities of one or more of the family members, for instance, in the event of a family member's bankruptcy or insolvency, and in safeguarding against profligacy of a family member.

7 A family trust deed generally has many other potential benefits, including overcoming issues about challenges to a will following a death of a family member, such as Mr or Mrs Sydney. This is subject to the notional estate provisions in the *Succession Act 2006 (NSW*),

Elements to consider in the trust deed to shelter trustee liability

8 The law of trusts is the creation of equity, not of parliaments. The purpose of every trust instrument (trust deed) is to give effect to the intention of the settlor.

9 The client, in the present case, is advised to create a discretionary family trust (i.e. a living trust/an inter vivos family trust) to own and operate various properties including active operating businesses. For the purpose of this essay, a family discretionary trust called *Sydney Family Trust (“SFT”)* is established by a trust deed.

10 The duty to observe the terms of the trust has always been considered to be “the most important of all the rules relating to the rules of trustees.” (*Underhill and Hayton, Law of Trusts and Trustees, Butterworths, 19th edition 2016)*

11 The trustee, in discharging its fiduciary and onerous obligation to the trust, cannot be relieved from liability unless otherwise exempted by the express terms of the trust or the court of equity.

12 On the matter of construction of a trustee exemption clause, the leading English Court of Appeal decision in *Armitage v Nurse (1998) Ch 241* is authority for the proposition that a trustee could be excluded from liability from any cause whatever “unless such loss or damage shall be caused by his own actual fraud” (the exemption clause which was at issue at the trial). This case also sets outs the principle that English trustees might be relieved of liability for gross negligence by an appropriately worded exemption clause in the trust deed.

13 Milllett LJ, in this case, decided in favour of the defaulting trustee, confirming that there is "an irreducible core of obligation owed by the trustees to the beneficiaries and enforceable by them", and that absent such core obligation, which is the minimum necessary to give substance to the trusts, there will be no trust in the eyes of a court of equity.

14 In other words, trustee's "core" duties are duties imposed on trustees from which the trustee cannot be relieved by the trust deed or, for that matter, by the court exercising its inherent jurisdiction (*Paragraph 9.270 The Law of Trusts, Ford & Lee, Thomson Reuters, Australia, loose-leaf services).*

15 It is therefore necessary to consider the scope and extent of a trustee's power and duties. The narrower and heavier its burden, the greater the risk of breach of trust and personal consequences. The wider its power and the lighter its burden, the lower that risk. Included in our formula is the content of the express provisions in the trust deed in relation to the exemption or exculpation clauses which can operate to pardon a trustee for breaches , but not including the "irreducible core duty" to act in good faith for the benefits of the beneficiaries.

16 As to drafting a trustee exemption clause, there are many statutory precedents, but in drafting it is best to use a form based on that approved in *Armitage v Nurse* (*Paragraph 5.160, Drafting Trusts & Will Trusts in Australia, James Kessler & Michael Flynn, 2017, 2nd edition, Thomson Reutors)*. The exemption clause can be worded in this manner: "*Exculpation from breaches of trust- To the extent permitted by laws, the Trustee is not liable in connection with the trust, any conduct which constitutes a breach of trust, even if that results in loss or damage to, or a reduction in the value of the Trust Assets, as long as that conduct was in good faith and the Trustee honestly believed that it was in the best interests of the beneficiaries the trust*." (*Commercial Trusts, Chapter 4 & Part 4 of Appendix 4 on "A Model Limitation of Liability Clause", Nuncio D'Angelo, Lexis Nexis Butterworths 2014)*

17 When preparing a trust deed, the purpose of the trust must be consistently kept in mind and care taken to ensure the deed's provisions allow these purposes to be achieved.

18 The purpose of the *Sydney Family Trust*, by reference to the facts contained in the topic question, is to: a) grow the collective wealth of the family; b) leave a legacy for future generations; c) provide a regular income stream for family members; d) assets protection; and e) look after each family member's personal financial affairs.

19 Subject to a trustee exemption clause that may otherwise be inserted, the elements that must be considered in the trust deed are set out below.

20 *First,* there is a need for a succession plan and a viable strategy for the transfer of the ownership, management, and financial responsibility of the family business. Succession planning for a family business will generally be more complex than for a non-family business. There is a need to, however, distinguish management succession of a trustee from management succession of trust operations and benefit administration, as the composition of active beneficiary pool may change over time.

21 In the Australian context, a non-resident investor can invest in, or otherwise set up a business in Australia through a trust structure. The trust's business assets will be held by a trustee (preferably a corporate trustee for the *SFT*, rather than an individual trustee), and the trustee will carry on the business of the trust for the benefit of its beneficiaries. Corporate trustees benefit from the company tax rate, and have flexibility in distributing or retaining income from the business.

22 In relation to matters about tax consequences attached to a beneficiary, several factors must be considered, including the tax residency, nationality or citizenship, habitual residence, domicile of the will (if any). *Division 6 of ITAA36* contains a number of measures to ensure, that Australian tax cannot be deterred on trust income accumulated in a non-resident trust where it is ultimately for the benefit of an Australian resident beneficiary. It is important to note that where net income of

the trust is wholly or even partly attributable to foreign sources, a trustee will only be liable to tax on that income if the trust is resident income. Conversely, the non-resident is generally liable to tax only in regard to the net income that is attributable to Australian sources (see further below).

23 *Second*, whether the family's expectations or objectives for the business are achievable, which comes down to deliberation about: a) do they prefer profit now or long term accumulation of wealth in relation to the underlying operating business? b) will there be multi-jurisdictional family members; c) are there any non-resident beneficiaries affected by the Australian tax law? d) is it an Australian resident trust, as opposed to a foreign trust?

24 *Third*, the client should also consider ways to mitigate or control risk-management issues, and put the proper mechanisms in the trust deed. Several concerns regarding family assets and potential risks are:

i. any need to isolate an Australian part of the family from foreign part of the family

ii. how is balance to be achieved between ownership, management and succession through viable wealth governance

iii. what the trustee can and cannot do in dealing with the family assets - should the trustee be allowed to take a more active role in managing the operating business

iv. how to balance control, safety and succession

v. how to align the trust structure, business structure and family objectives

vi. the relationship between resident beneficiaries who are running family business (including owning real property)

vii. the role of intended non-resident beneficiaries in operating the underlying business

viii. the interplay between trusts and trading companies.

25 *Fourth,* efective clauses should be included in the trust deed in order to effectively safeguard abuse of powers. Trustees have complete control of the trust and are at risk of temptation to profit from that control. That temptation can be combated, if Mr and Mrs Sydney are not trustees of the *Sydney Family Trust*, by the appointment of several trustees who are independent of each other. Where there is a sole trustee, or a sole person who has control of the trustee, the temptation to profit from the trust may be practicably irresistible, especially in case of a family trust where discretionary beneficiaries may not have the means to object to a breach of trust. It is necessary to give careful thought to whether there should be co-trustees, or whether there are advantages to trustees incorporating themselves. If a corporate trustee is appointed, they should consider appointing a selection of directors and shareholders among the family members. In principle, an at-risk beneficiary should not be a shareholder of the corporate trustee.

26 For the purpose of giving governance protection to the *SFT*, a corporate trustee in the form of a private proprietary limited company should be established. Incorporation would also avoid the problems caused when a personal trustees becomes incapacitated, and would save the formalities of amending title registers of trust property, for example, realty or shares when a trustee retires, or dies. A juristic person (in the form of a corporation) as a trustee does not die, but an individual trustee does. A foreign corporation may own property in Australia and act as a trustee.

27 *Fifth,* the clients should establish a "watch-dog" mechanism. In most discretionary trust deeds, the power given to the appointor is a wide and decisive one. The appointor should be given the power to remove the trustee and appoint a new trustee, and to retain reserved power that certain decisions by the trustee requires the consent of the appointor. For example, the appointer's consent should be required before capital is distributed, or loans are made to beneficiaries.

28 Various terms are used to describe the person given such powers, including appointor, principal or protector, or enforcer, whose main functions it is to ensure that the trustees further the purposes of the trust. The purpose of the appointor is normally to hire and fire trustee, and provide oversight and external control on any material changes to the initial trust arrangement.

29 The trust deed should provide for a "protector" (or guardian) to oversee the management of the family trust. The protector can attend to the interests of the beneficiaries by controlling some of the trustee's functions, and/or ensure that the settlor's intentions are put into effect. In many jurisdictions including Australia, such role has been described as a fiduciary. (*Ford 8180, and LGSS Pty Ltd v Egan (2002) NSWSC 1171 per Austin J at (108).)*

30 In relation to the *Sydney Family Trust*, the trust deed should expressly give several powers to the Protector, including:

i) conduct periodic reviews of the administration of the trust

ii) approve self-dealing by the trustees

iii) remove and appoint trustees

iv) withhold consents where requisite before the trustees make any discretionary payments to objects of a discretionary trust or power

v) withhold consent where requisite for sales of particular shareholdings or other trust property

vi) withhold consent where requisite for trustee's proposed exercise of a power to amend the administrative or managerial terms of the trust

vii) direct generally or only in specific areas the exercise of trustee's investment or other managerial discretions

viii) make or approve additions to, or deletions from, the class of beneficiaries or objects of powers

ix) amend any clause in the trust deed, other than the one setting out beneficiaries or objects of the settlor's bounty, in any fashion that the protector subjectively considers will better further the purposes of the settlor. (*Underhill & Hayton, Law of Trusts and Trustees, 19th Edition, 2016, Para 1.80)*

31 *Sixth,* consideration should be given to whether the trustees should hold office for a given period of time, such as, for example 3 years, if the family has several members who are competent and willing to take up the position of trusteeship.

32 *Seventh,* the trust deed should give the trustee unlimited investment power in pursuit of the income-productive and assets preservation purposes. Additionally, the trustee may need the power to invest out of jurisdiction.

33 *Eighth*, depending on the complexity of the matter in terms of the size and location of the family assets, using different trustees for different trusts might be a sensible option, particularly when the family has various assets globally, which are subject to different jurisdictions.

34 *Ninth,* it may be necessary to insert a default clause, which provides that the trust funds shall be held on trust on behalf of the primary beneficiaries (i.e. Mr and Mrs Sydney), or otherwise direct that property should pass to named children or grandchildren of the clients or more distant relatives in the event of the death of the direct family. The person who receives the trust property, in the circumstances, is called "the default beneficiaries"- which can, in a great way, meet tax-advantage purposes (see the ensuing discussion about undistributed income/income accumulation.).

Factors the trustee should consider during the trust administration relating to the underlying operating business

35 In dealing with the assets of a family trust, it is important to isolate Australian assets from the family's overseas assets, in the event that the family will not be tax-advantaged under the Australian tax regime. The trustee may need to take the following factors into account in the course of the trust administration.

36 *First***,** the trustee is advised to have both active assets (such as the goodwill of the business of which liability can be incurred), and passive assets (such as shares where no liability can be incurred once they are fully paid up) kept in separate trusts by different trustees. This protects the passive assets from being used to satisfy a claim made in relation to an active asset. The reason is that if one trust held both active and passive assets, and if a claimant successfully brought an action against the trustee of the trust, it might be necessary to sell the passive asset to satisfy the order made by the court. Generally, this could not happen if a different trustee held the passive assets in a different trust.

37 *Second,* the trustee must also consider other trust-related matters, including: i) isolate assets used for family support from the capital engaged in pursuing an active business; ii) isolate assets used in core/active business operations from that needed to support trade creditor obligations; iii) isolate assets needed for long-term collective family support from those needed for immediate beneficiary welfare support requirements; iv) isolate investment capital from inappropriate risk in achieving appropriate financial returns; v) isolate capital under management from financial abuse risk by estate managers and decision maker; vi) isolate estate capital from the effect of disputes between beneficiaries and estate manager; and vii) isolate Australian part of the family business from overseas parts of the family business.

38 *Third,* on the basis that the *SFT* will operate the business through a company as trustee, the control /ownership of the business will be held at 3 levels: I) directors of the corporate trustee, for example, *Sydney Investments Pty Limited* (Trustee), will be the clients Mr and Mrs Sydney, and the trustee company will make decisions regarding the governance and management of the business and the distribution of income and capital of the trust to the beneficiaries. II) the shareholders of the corporate trustee (Mr and Mrs Sydney equally) have the power to remove and appoint directors. Therefore, if the company directors of the corporate trustee were not making decisions shareholders approved of, the shareholders may remove them and appoint new directors. III) the Protector or Appointor of the discretionary family trust has the power to remove the existing trustee and appoint a replacement trustee. Therefore, the Protector/Appointor has the ultimate control of the trust. In this case, Mr Sydney is suggested to be the Protector, and so he has the ability to remove *Sydney Investments Pty Ltd* as trustee of the *Sydney Family Trust* and appoint a new corporate trustee. As a result, Mr Sydney has the ultimate control of the trust and the business that it conducts.

39 *Fourth,* there is utility to establish a professionally-run family office so that the private financial affairs, and capital of the family, can be managed across investment classes such as direct property, listed shares, business interests, philanthropic pursuits and cash reserves. A family office, as a key management approach, can assist in the operation of the family trust, and maintain and protect the family's wealth whilst preserving their family values and legacies across generations.

40 A professionally-run family office can effectively reduce the risk of assets-reduction resulting from interests-divergence, personality clashes or otherwise conflicting investment approaches of various family members. If some family members want to go their own way, a well-run family office may be better placed to establish a value for their equity, and to arrange funding to pay them out while keeping the core assets intact for the others.

41 *Fifth***,** it may be suitable to set up an Internal Investment Committee that meets regularly (say every quarter) to determine the investment strategy and asset allocation, select fund managers to make selections of particular investments within each asset class, and monitor the performance of the investments and asset managers. As the trust estate includes underlying operating business in different markets worldwide, it is the duty of the trustee to render the assets productive, and this is so even if the trust instrument does not expressly so provide. An Investment Committee is capable of affording protection available to trustee, unlimited investment power, delegation and carry out a business plan according to the Modern Portfolio Theory developed by Hoffman J the *English Chancery Division case of Nestle National Westminister Bank plc (1994*).

42 *Sixth*, additionally and or alternatively, depending on the multitude of the potential beneficiaries of the *SFT* and the nature of dynamics of them, the trustee may need to consider forming a Family Council to operate in either a family business or family office environment. This may be useful in a family office environment where there may be a large number of family members affected by the operation of the family office. The Family Council will act as a board for the family, and is the link between the family office and the interests of all family members. It is fairly common where the family is too numerous to effectively liaise directly with the board in family meetings and, in such a case, it is where the family develops its purpose and values, arranges family events, and monitors the welfare and development of family members. (*Chapter 16, Family Business Succession Guide, Sue Prestney, 2nd Edition, 2014, Thomson Reuters)*

Reasons that a trust could be a valid succession planning tool from a tax perspective under the Australian law

43 This comes down to a discussion about the taxation of discretionary trusts. The leading principle of the tax law is that income should only be assessed if it has a sufficient connection with the taxing country. Australian residents are taxed on their worldwide income (because their residency establishes the necessary connection with Australia), and non-residents are taxed only on income from Australian sources.

44 The Australian income tax relating to trust income generally applies to a person in the capacity of trustee or beneficiary of a trust, rather than applying to the trust itself. A trust is not a separate taxable entity. This is despite the fact that a return of trust income must usually be filed by the trustee and that, in certain circumstances, the trustee may be liable to be assessed and to pay tax on the whole or part of the trust income in that representative capacity.

45 The principal taxing provisions in *Division 6 ITAA36,* which relates to taxation of the trustee and beneficiary, are as follows:

- Section 97, which imposes tax upon the <u>beneficiary</u> where the beneficiary is presently entitled and not under any legal disability;

- Section 98, which imposes tax upon the <u>trustee</u> where the beneficiary is presently entitled but under a legal disability;

- Section 99A, which imposes tax upon the <u>trustee at punitive rates</u> (the maximum individual marginal tax rate, ie 45% of entire amount for the income year 2018-19) where the net income of the trust estate is not liable to tax pursuant to S97 or S 98; and

- Section 99, which only applies if S 99A does not apply. The section imposes tax upon the trustee (at concessional progressive rate) where the net income of the trust estate is not liable to tax pursuant to SS 97, 98 or 99A.

- Section 99A does not apply if in the opinion of the Commissioner of the Australian Taxation Office it would be unreasonable that it apply.

46 There is no definition of the term “presently entitled”, but the words have been judicially considered from time to time. There is authority for the proposition that the words mean the right of a beneficiary to immediate payment, and not merely that the beneficiary had a vested interest in the income.

47 Subsequently, Kitto J considers that “presently entitled” was held to refer to “an interest in possession in an amount of income that is legally ready for distribution so that the beneficiary would have a right to obtain payment of it if he were not under a disability.” (*Taylor v FCT (1969) 123 CLR 206: 69 ATC 4026)*

48 There is also no definition of the term “legal disability”. It has been assumed that it includes the disability of minority.

49 The concept of “present entitlement” in the *ITAA 1936* is extended by the Act, and in a number of situations a beneficiary will be deemed to be presently entitled*. S 101 ITAA36* (with the section title Discretionary Trusts), is a deeming provision, which provides that “ For the purposes of this Act, where a trustee has a discretion to pay or apply income of a trust estate to or for the benefit of specified beneficiaries, a beneficiary in whose favour the trustee exercises the trustee’s discretion shall be deemed to be presently entitled to the amount paid to the beneficiary or applied for the beneficiary’s benefit by the trustee in the exercise of that discretion.”

50 *Division 6 ITAA36* is predicated on the principle that tax liability falls on the person/s into whose hands or under whose control the trust income ultimately comes. Therefore, if the trustee retains control of the income, the liability is imposed on the trustee. In contrast, if there is an entitlement on the part of a beneficiary to call for a distribution of the whole or some part of the trust income, the liability to tax respecting that income is imposed on that beneficiary.

51 Other advantages of using discretionary trusts can be outlined as follows:

52 *First*, by careful selection among discretionary beneficiaries, the trustee may determine which of the beneficiaries should become entitled to the income, having regard (among other things) to the marginal rate payable by each of the beneficiaries concerned. The *SFT* as a discretionary trust can therefore achieve the twin goals of income-diversion and income-splitting. Because the trustee is able to determine each year which beneficiaries will be entitled to income, and in what proportions, the *SFT,* in the form of a discretionary trust, can provide the flexibility to distribute the income to one or more different beneficiaries each year, taking into account their individual circumstances at the time, including their tax position.

53 Flexibility afforded to a discretionary trust, in tax-advantages terms, can be outlined as follows.

A) it allows trust income or capital to be distributed between beneficiaries in the most tax effective manner. The trustee is required to distribute the income in each year between the beneficiaries, or to accumulate it (although accumulation may result in more tax being paid on that income). The trustee can elect to distribute income to any one of the primary beneficiaries (such as Mr and Mrs Sydney) or general beneficiaries (such as the lineal descendants of the couple), none of them have any enforceable right to require that any portion of income, or fixed sum be paid to them in any year.

B) the trustee has similar power to distribute capital during the life of the trust.

C) the advantage of carrying on a business by way of a trust is that, certain taxation advantages arising from the imposition of Capital Gains tax apply in relation to discretionary trusts. These advantages are not available (or available to a lesser extent) to unitholders in a unit trust and shareholders in the company.

54 For illustration purposes, assume Mr Sydney has established 2 separate discretionary trusts for the family, with different trustees. The scenario will look like these.

i. Mr Sydney incorporates a company (A Pty Ltd) of which he is the sole director and shareholder. He also incorporates I Pty Ltd. Mr Sydney uses both A Pty Ltd and I Pty Ltd as trustees of the discretionary trusts he is setting up (the *Sydney Family Trust* and the *Sydney Investment Trust*).

ii. The settlor, Ms Y who is Mr Sydney's friend, pays a nominal sum, say A$10 to each of the trustee, A Pty Ltd and I Pty Ltd, and executes the trust deed. The settled sums are the initial trust assets (ie the trust funds) grow throughout the life of the trusts as the trustees acquire further assets for each of the trusts.

iii. A Pty Ltd and I Pty Ltd execute the trust deed and so complete the establishment of each trust. Each trust deed provides for an Appointor/Protector and Mr Sydney chooses his friend Mr Z to be the appointor for each trust, together with himself and Mrs Sydney. Each trust has Mr Sydney, his wife Mrs Sydney, and their 3 children B, C, and D as primary beneficiaries. The terms and beneficiary of each trust are identical even though each has a different trustee and each will hold different assets. A Pty Ltd (as trustee of *Sydney Family Trust*) holds the active assets, and I Pty Ltd (as trustee of the *Sydney Investment Trust*) holds the passive trusts.

iv. Child D transfers to the *Sydney Family Trust* a website business that she has previously established and operated (the business is an active business). Mr Sydney transfers to

Sydney Investment Trust an investment and the share portfolio that he and his wife Mrs Sydney have acquired (these are passive assets). In fact, the business and investment assets will be transferred to the A Pty Ltd, and I Pty Ltd, respectively to hold on the terms of the trusts set out in each of the trust deed.

v. As to the trusts trade, A Pty Ltd, as trustee of the *Sydney Family Trust*, now owns the website design business. I Pty Ltd, as trustee of *Sydney Investment Fund*, periodically buys and sells shares. From the profit of share trading, I Pty Ltd purchases a holiday home for the Sydney family. The Sydney family uses the home sometimes and at other times rents it to holidaymakers. B marries Z. D continues to be engaged in the website design business, now conducted by A Pty Ltd as trustee of the *Sydney Family Trust*. C goes to university. As at the end of the 5th financial year of its operation, I Pty Ltd, as trustee of the *Sydney Investment Trust*, has assets with a market value of A$850,000.

55 As mentioned, one of the tax advantage is flexibility in distribution of trust income. The *Sydney Family Trust* has, for example, income for the year of A$150,000, derived solely from the website design business. At the end of the 5th year of business, the *Sydney Investment Trust* has assets of A$850,000. Included in this figure is an amount of A$100,000, which represents net income that the *Sydney Investment Trust* has received throughout that year. The accounts of the *Sydney Investment Trust* now show this income to be consisted of: a) A$65,000 rent from the investment property; and b) A$35,000 rent from the holiday home. I Pty Ltd decides to **distribute** the income of the 5th year to the primary beneficiaries . It does not distribute to the primary beneficiaries equally; that is, D receives more income than any other beneficiary. This reflects the fact that rights to the income of the trust (and similarly, to its capital) are discretionary and can be distributed at the sole discretion of I Pty Ltd.

56 As to income tax calculations, if I Pty Ltd distributes the whole of the net income of the *Sydney Investment Trust* of A$100,000, that amount would be included in C's assessable income. In these

circumstances, the trust pays no tax no that income. However, if the trust did not distribute that income in its year of receipt (and was therefore deemed to have accumulated the income), the trustee would have to pay income tax on that amount at the top marginal rate (45%). C, the university student, by comparison, as an individual, pays tax on her income at the applicable marginal rate. Assume that C has no other income for that year. In this example, the trust will pay tax of A$45,000 (calculated at $100,000 x tax rate of 45%), and C will pay tax of A$24,632(calculated at $100,000 x rates applicable for the 2017-2018 income year) or A$24,497.00 (calculated at $100,000 x rates applicable for the 2018-2019 income year).(PS. The abovementioned tax treatment is, however, subject to Personal Services Income Rules and the operation of the tax avoidance provisions in Part IV A)

57 *Second*, as trustees are given discretionary powers to distribute income and capital among ascertainable beneficiaries. In a family trust where the powers of distribution are often exercised for the purpose of minimising taxation imposts, for example, by income splitting and capital distribution, the taxation profile of a given beneficiary may become a factor in the exercise of the power. Distributing to beneficiaries having an income of less than A$25,000 a year are obviously far more tax effective than distribution to those having an income of A$70,000 a year; and a decision to purchase a home as a residence for a beneficiary who has been living in rental accommodation is potentially tax effective.

58 *Third**,*** as to Capital Gains Tax (CGT) concessions, a discretionary trust may access to all of the CGT concessions on the disposal of the business assets. A discretionary trust has similar tax treatment to an individual. It is the flow-through nature of the taxation of discretionary trusts that results in this similar treatment.

59 A caveat must be given here. As it is the flow-through nature of the discretionary trust that allows it to access the CGT concession, the manner in which the amount of the capital gains is distributed must always be considered. For example, should the capital gains be distributed by the

discretionary trust to a company, the benefit of the 50% CGT discount would no longer be available. The benefit is no longer available because, although the 50% CGT discount may be applied at the discretionary trust level, *Sub 115-C ITAA 97* requires that when the amount of the capital gain is distributed to a beneficiary, that beneficiary must then gross-up the amount of the net capital gain to include the amount of the 50% discount. The 50% discount is then subsequently reapplied (after offsetting any capital losses held by the beneficiary).

60 Accordingly, when amount of the capital gain is distributed to a company, the company will not be able to reapply the 50% CGT discount after the amount of capital gain is grossed up. Effectively, this achieves a similar result as if the discretionary trust is unable to access the 50% CGT discount in the first place. Therefore, the amount of the net capital gain will need to be ultimately distributed to natural persons within the same financial year as that in which the CGT event generating the capital gain occurred. If such distribution is not made, the 50% CGT discount will not be available.

61 As previously mentioned, a company may be a trust beneficiary, whether acting as a trustee or as the ultimate beneficiary. A corporate beneficiary will pay, however, tax on income to which it is presently entitled at the company tax rate, which is lower than the maximum personal rate of tax. If the income was paid to the company, any distribution would be dividend when paid out to shareholders and would effectively bear tax at their personal marginal rate**.**

62 Take a standard discretionary trust as an example. Now the trustee owns the family businesses for the beneficiaries by way of a discretionary trust, in order to own and operate a business for a single family, hold the family's passive investments including shares or property, and to hold a family's interest in a partnership business. The income taxation consequences would be this:

i. income accumulation by the structure will be taxed at the highest marginal income tax rate (45%) plus the Medicare levy (2%), as long as the tax treatment provision pertinent to a testamentary trust will not apply (ie, the 'excepted trust income' provision under *s 102AG (2)(a)(i) ITAA 1936* is not applicable).

ii. Flow-through tax applies, so that income distributed by the structure will be taxed in the hands of the recipients at their income tax rate (such that a beneficiary may be taxed-advantaged, per above);

iii. there is flexibility to distribute income with special characteristics eg franked dividends to any one or more beneficiaries (subject to personal services income and Part IVA issues).

iv. the Capital Gains Tax consequences would be this: i) a 50% discount will be available; and as long as the small business concessions applies, then all the usual concessions will apply, namely, the 50% active assets reduction, a 15-year exemption (subject to the requirement of a 20% business participation in the trust, *per S152-55 ITAA 97)* , retirement exemption, and Roll-over.(*Paragraph 4-110 Tax Structures Guide 2016, Sladen Legal ,The Tax Institute, 11th edition, 2016)*

63 *Fourth,* a non-resident beneficiary who is presently entitled to foreign source income is not subject to Division 6 tax. .*For* clarity, a non-resident beneficiary who is presently entitled is only assessed on such of its shares of the net income of the trust estate as is attributable to sources in Australia. Specifically, a beneficiary who is presently entitled to a share of the trust estate in an income year and is a resident at the end of the income year is assessed on a corresponding share of the "net income" of the trust estate, excluding amounts attributable to a period of non-residence during the year and also attributable to a foreign source. However, if a beneficiary who is presently entitled to a share of the income of a trust estate is a foreign resident at the end of the income year, the trustee and the beneficiary are both assessed on a corresponding share of the net income of the trust income, excluding an amount that is attributable to a period of non-residence and is also attributable to a foreign source. The tax paid by the trustee on this income is deducted from

the amount payable by the beneficiary.(*Paragraph 23.100 Ford & Lee, The Law of Trusts, Thomson Reuters loose-leaf services)*

64 As early as 2017, several Australian states including NSW have imposed higher rates of stamp duty and land tax on individuals, trusts and companies who are not residents in Australia. It should be noted that a non-resident beneficiary (unlike a resident beneficiary) is taxed at a higher rate and isn't entitled to tax-free threshold. That said, Australian beneficiaries of foreign trusts must be alert to the scope and operation of s99B and s99C of *ITAA 36*.

65 *Fifth,* a discretionary family trust in Australia can be the subject of a family trust election which gives certain tax advantages, provided that the trust meets several requirements including the family control test, and the trustee makes distribution of trust income only to beneficiaries of the trust who are within the family group. *It must be pointed out, that a deed might refer to the trust as a family trust, but it is not a family trust for tax purposes until it makes a family trust election (s272-275 of Scheme C ITAA 36)*

66 By way of mention, in relation to a Testamentary Discretionary Trust (TDT) (where a trust is established through the operation of a will), beneficiaries who are presently entitled to estate income or have received a distribution from the estate by way of an absolute gift which now accrues income, will have that income added to his or her personal income and taxed at marginal rate. Minors within the class of beneficiaries receive the full tax-free threshold (currently A$18,200 for 2018-2019) for income distributed from a TDT. However, unlike a TDT (where a full tax-free threshold set at A$18,200 is available to minors), under *Division 6AA of ITAA 36* the position is different for distributions from family trusts established inter-vivos, where each minor beneficiary may only receive the first A$416.00 tax free.

67 There is also a need to give advice in relation to ease of succession of the trust, so as to enable the trust to last for a long time. The statutory period of up to 80 years is set out in the *Perpetuities Act*

1984 (NSW), but the life of a trust is indefinite under the corresponding legislation in South Australia. Equally important, proper arrangement should be made for the control of the trust to changes over the generations without major obstacles.

68 In conclusion, standard trust drafts need careful planning and thorough review, and do so instruction on the present subject of discussion. A family trust deed is not a one-size-fits-all solution, consideration must be given to the various matters mentioned in the preceding paragraphs. (END)