YOUR GUIDE TO UNDERSTANDING OWNERSHIP STRUCTURES & TRUSTS

by Ken Raiss

SERIES

Grow your Wealth

Metropole
WEALTH ADVISORY

A Trust Companion for clients of Metropole Wealth Advisory

INTRODUCTION

This guide has been prepared for clients of Metropole Wealth Advisory to help them understand a little more about using trusts as a structure for owning assets including investment properties.

Firstly, we'll explain a little about why to consider using structures to own your assets, then we'll outline about the common structures used by sophisticated investors and then there will be some guidelines and practical steps to using trusts.

STRUCTURES FOR SUCCESS

The main reason sophisticated investors form business entities to own their assets including properties has nothing to do with tax.

However, how you own your property investments (not your owner-occupied home), or more to the point, who owns your investment properties, will affect how much tax you pay.

The main ownership options fall into two broad categories: individual ownership and ownership through a business structure.

You've possibly read that most sophisticated property investors own no (or very few) assets in their own name, but control everything through correctly established business and investment structures. This allows them to protect their assets, legally reduce their tax and pass them on to future generations because they are owned in companies, trusts or a combination of both.

The purpose of this Trustee Companion is to help you understand how your Trust "works".

When considering which structures to use to own your assets you need to think about the following issues:

1. **Liability protection** – minimise the risks of being sued.
2. **Asset protection** – protecting your assets if you do get sued.
3. Legally maximising your **tax minimisation** opportunities.
4. **Accelerating your wealth creation** – different structures will have different cash flow outcomes and will help you sustain and grow your property portfolio.
5. Optimising your **opportunities**.
6. **Cash flow management**
7. **Estate planning** – how your assets will be transferred to your beneficiaries after your death.

Common types of investment entities

There are four basic ways you can own your assets or investments in Australia, each with its own benefits and disadvantages. Let's consider them in a bit more detail:

1. **Your personal name**

Most people own their home in their own name, and most Level 1 and 2 investors hold their properties in their own names, making them fully responsible for all their debts and liabilities.

When you own assets in your own name, you are taxed at the personal income tax rate (Marginal Tax Rate is the rate of tax you pay on the next dollar of income), which as we've already explained, varies depending upon how much you earn. But when you add the Medicare and other levies to the equation, it could mean losing close to 50% of your income to the ATO.

The **advantages** of investing in your own name include:

- It's a simple and cheap way to operate with minimal accounting and no set-up costs
- If you are a high income earner, you may get income tax benefits through negative gearing
- Capital Gains Tax concessions are greater for individuals than for companies which do not get benefit from the 50% CGT discount.
- In some States reduced land tax liabilities. This benefit may only be available on your first few investment properties.

The **disadvantages** include:

- You deny yourself the tax advantages available to companies and trusts
- You cannot distribute income to your partner, children or other structures you are related to, which means that once you enter the top tax bracket you pay a punitive rate of tax
- Have a higher tax liability when profitable (income or capital)
- All your assets are exposed to creditors if you fall into debt or if you are sued
- Upon your death, your assets are distributed according to your will, rather than continuing in perpetuity as they would if they were owned by a company or trust.
- In some States your land tax liabilities can be increased as your personal threshold is exhausted

Joint Ownership

There are two principle variations to this structure.

- Joint Tenancy. This type of structure is typically used between life partners. In this structure ownership passes to the surviving partner on the death of the other. For tax purposes each partner is treated as owning 50% of the property and share all income and expenses at this percentage.
- Tenants in Common. In this structure each party owns a pre-determined percentage which is identified on the contract of sale and subsequent title. For tax purposes each partner is treated as owning their specified percentage of

the property and share all income and expenses at this percentage. On the death of one party their share goes to their estate for distribution in line with the deceased will. The parties may have an agreement on how ownership of the deceased is to be treated on the death of the other.

All parties are usually required to go on the loan application and give guarantees and only one land tax threshold is available between the parties.

The use of joint tenancy or tenants in common can be applied to any structures used i.e. individual. partnership, company or trusts.

2. **Partnership**

If you own your investments with another person in both your names, you are acting as a partnership. This is different to joint tenancy or tenants in common as the legal relationship comes from the partnership agreement. Legally the individuals within a partnership are not treated as separate entities, meaning each person is jointly and severely liable for all of the actions of the other partners.

That's fancy legal talk to say that if one of the partners enters into a commitment, you and the other partners are equally responsible. In other words, if your partner fails to honour an obligation or repay a debt, you could be asked to pay the entire debt on your own.

Partnerships are treated in a special way for tax purposes. They have their own tax file number and their own separate tax return. The partnership doesn't actually pay tax, but the taxable profit is split between the partners and disclosed in their own personal tax returns at the percentage agreed on in the partnership agreement. This means that partners within this type of structure pay tax at their personal tax rate, which may not be an ideal situation.

Interestingly losses from a partnership can be "passed on" to the individual partners.

There are very different legal and tax outcomes between a partnerships and or joint tenants or tenants in common, and changes to partnership percentages will usually trigger a Capital Gains Tax.

The advantages and disadvantages of a partnership are similar to that of owning assets in your own name.

The **advantages** include:

- It's a cheap and simple way to operate with no establishment costs
- Income or losses can be split amongst the partners
- Partnerships are also subject to Capital Gains Tax exemptions.
- If in joint ownership, title automatically passes over to surviving partner.

The **disadvantages** of partnerships include:

- Once you receive a substantial amount of income, you are taxed at your personal tax rate and there's little you can do to reduce your taxes
- Just as when you own assets in your own name, there is no asset protection and you expose yourself to being sued
- Higher concerns in relation to asset protection as you not only have to consider your actions but now those of parties within the partnership.

- You are liable for all obligations of your partners Now this is very important as most investors don't realise that when they apply for finance for the next property the banks will assess you as if you are liable for 100% of the mortgage payments for your joint loan, however they will only consider your proportion of the rental income. I know that doesn't sound fair, but it means that a partnership can considerably restrict your future borrowing capacity.
- On the retirement or death of a partner, you may be subject to Capital Gains Tax implications
- Only one land tax threshold is available to a partnership not one per partner
- Depending on type of partnership you may find you are suddenly partners with an unknown party i.e. a relative of the deceased partner.

3. **Company**

A concept that's sometimes difficult for people to understand is that both by law and for tax purposes, a company is considered a separate legal entity to you. It's essentially treated like a different person.

The **advantages** of investing in a company name include:

- It's a simple and relatively cheap
- A company can take advantage of the lower tax rates and so less after tax funds are required for deposits
- When using a company, you still need to decide on who will be the shareholders and so you get back to the same question of ownership
- There is limited liability with a company. This means that in a company the shareholders would not normally have to pay the debts of the company.
- Companies normally have the same land tax threshold as individuals, but this can be negated depending on which structure owns the shares.

The **disadvantages** include:

- No 50% general CGT discount is available to companies and so there is the potential to pay double the capital gains tax on a sale
- If an individual is the shareholder they could lose any asset protection as the shares would be available to a receiver in bankruptcy and they can then decide what to do with the assets in the company.
- Your distributions are fixed each year to the shareholders in proportion to their ownership. This means cannot distribute income to non-shareholders such as your partner, children or other structures you are related to, unless the shareholder is a discretionary trust, which means that once you enter the top tax bracket you pay a punitive rate of tax
- Potentially have a higher tax liability when profitable (income or capital)
- If there is an individual shareholder, then all their assets are exposed to creditors if you fall into debt or if you are sued

- Upon your death, the shares in the company if individually owned are distributed according to your will. This then continues the disadvantages to the next generation.

4. **Trust**

For many investors, a trust is one of the best entities in which to hold investment assets. Trust types are basically split into two categories that confer different rights:

- Fixed Entitlements
- Discretionary Entitlements

However, because they're a little complicated, trusts tend to be poorly understood, so we'll explain about trusts in upcoming chapters.

5. **Self Managed Superannuation Fund (SMSF)**

An SMSF is just another type of trust which has been be set up with the sole purpose of deriving retirement income for its members and the funds held on trust cannot be accessed until meeting a condition of release.

Since 2007 when SMSF's were allowed to borrow (Limited Recourse Borrowing Arrangement – LRBA) to invest in property, more investors are using this vehicle, but it's critical to get independent financial planning advice before setting up your SMSF and then deciding on asset purchases. Borrowing under a LRBA has very specific requirements which must be fully followed.

As the rules for SMSFs are complex and changing, we can only offer you the following overview:

The **advantages** of investing in a SMSF include:

- Nothing beats superannuation as a tax effective way of accumulating wealth. In the accumulation phase a SMSF is taxed at the rate of 15% on income and 10% on capital gains. In pension phase a SMSF pays **no tax** and pension payments to the member attract **no tax**. What this means is that you can invest in a residential property and sell it after you turn 65 or earlier if meeting a condition of release and pay no CGT – this could literally save you hundreds of thousands of dollars.
- An SMSF provides one of the strongest forms of asset protection – it is even protected from a trustee in bankruptcy when used in the normal course.
- Control – you have complete control over your SMSF rather than entrusting your future financial well-being to a complete stranger, who will take your hard earned cash and invest it in shares and managed funds that may or may not perform. In line with the sole purpose test you cannot use funds for your personal benefit.
- Operating costs can be lower than an industry or retail fund as administration costs are based on time spent not assets held.

The **disadvantages** of investing in an SMSF include:

- Your money is locked away in the fund until you turn 65 (or possibly earlier if you meet a condition of release,) even though you can start taking a pension from your fund once you turn 55 if born before 1 July 1960.

As of 1 July 2017, the tax benefits have been greatly reduced, so you need to seek advice as to your specific circumstances before making any superannuation decisions. The 65 year old rule increases depending on the date of birth.

- Setting up the fund and lending structures for the fund can be costly, but these are often outweighed by the benefits.
- There are strict restrictions on borrowing funds in your SMSF and you cannot normally borrow money cosmetically renovate your property and internal funds must be used for improvements. Another disadvantage is you cannot develop a property in your SMSF while there is debt on the property or the property is used as security (Single Acquirable Asset - SAA).
- You cannot refinance when market value increases to then reinvest.
- You need to have the cash to do it. This is not a strategy for someone with a small amount of cash in their super fund. As a general rule, the ATO advises that a minimum $200,000 is needed to set up an SMSF.
- The confusion. There's no denying that managing your own super fund can be a minefield of complicated rules and regulations. Get something wrong and you could end up paying hefty penalties. Of course, you can always pay a professional to manage it on your behalf.

Selecting the right structure

So, what is the right structure for you? As every reader's circumstances will differ, you should seek the advice of an accountant or tax lawyer who understands your needs.

John, one of my clients, once shared this story with me and I thought I must share it with you …

Four men walk into a pub: an accountant, a lawyer, a banker, and an insurance broker.

If you're waiting for a punch line, there isn't one. Other than if you ask these four people the question, "What is the right structure for me?" each would give you a different answer.

The accountant would explain how the different structures are taxed differently and some will minimise the tax you pay.

The lawyer would probably suggest you should not own any assets in your own name because holding assets in certain structures would protect them if you were sued.

The banker would explain if you want your company or trust to borrow money, you will have to give a personal guarantee to the bank to stand behind your structures.

And the insurance broker may tell you not to bother setting up complex structures because you can protect yourself with public liability insurance. I would disagree. Ask him what happens when claims are made and the insurance company tries to get out of paying!

The bottom line is every investor's situation is different, so there is no "one rule fits all". But this point is so important I will say it again; all the sophisticated investors I know

own nothing in their own names but control everything through companies and trusts.

Remember how I said, begin with the end in mind? Understand what your investment portfolio will look like in the future and have the right structures in place to account for that.

This may actually mean different structure for different situations. While it may be cheaper to have the administration completed for individual ownership the additional costs when using a structure are normally only marginally more and would easily be offset from the benefits. Look at the whole picture and not just one element.

Notice I said “structures” not “structure.” This is because sophisticated investors use a number of different ownership structures. For example, you might hold your own home in your own name, a number of property investments in a family discretionary trust and another investment property in your SMSF.

When deciding what will be the optimal ownership structure for your next property purchase, here are some of the factors you and your advisors are likely to consider:

- Your current level of income and what your income is likely to be in the future.
- Are you married, does your spouse work, do you have children and how old are they?
- Are you likely to be sued because of your occupation?
- Are you in business or do you intend to set up your own business? Just as important is what structure will your business operate from.
- How long until you plan to retire?
- What investments do you currently own and in which entity?
- How much cash or equity do you have available to invest?
- How is the property financed?
- What are the short, medium and long term cash flows from the investment property?
- What do you anticipate doing to the property and over what time period.

As you sit down with your advisor at Metropole Wealth Advisory you will see that it is unlikely that only one structure will suit you.

Different structures will affect your income tax benefits, land tax, capital gains tax and cash flows. Each has its pros and cons and by using a combination of structures you will get the best blend over your property portfolio.

And even if you use a trust you need to set up the correct trust as there are different types that operate completely different. Use of the wrong trust can have severe negative consequences.

It is important to remember the dominant reason for setting up any structure cannot, and should not, be to minimise your tax, as this contravenes the anti-tax avoidance provisions of the Tax Act.

You must have other valid reasons to justify setting up your ownership structures in a certain way. In fact, it may be a good idea for either you or your accountant to document the reason you set up your structures so there is no confusion in the future.

Remember; when you fail to plan, you plan to fail, so let’s explain a little more about what a company is in the next section.

WHAT IS A COMPANY?

The first thing you need to know about a company is it is a separate legal entity.

Even if you are a director and own shares in the company, in the eyes of the law and the tax department it is another entity from the owners (who are called shareholders or members). Your responsibilities and accountability are different for each position held.

But it is not treated like a person as it is subject to different tax laws and a Commonwealth law called the Corporations Act.

The Australian Securities and Investment Commission (ASIC) regulates companies. This is an independent government body that aims to provide protection for consumers and businesses in their dealings with companies and to ensure that companies:

- operate according to the law
- report their activities
- maintain proper records, and
- maintain an information database on company details.
- operate in the best interest of all members
- do not operate with a conflict of interest
- operate without fraudulent intent and are solvent

The most common type of company is a private company with limited liabilities. You might be familiar with the initials “Pty Ltd” that follow a company’s name; well this indicates a private company with limited liabilities.

This is a typical company that most investors or small business owners use.

There are other companies, such as public companies, companies with limited liability and unlimited liability companies that have specific purposes, but these are unlikely to be used by the readers of this book.

The ownership of the company is through its members and the percentage of shares that each own. Shares can be created that offer different benefits. Each shareholder of each type of share must be treated equally. A company operates under a set of rules called its constitution and ASIC have a base line of what must be included in a constitution even if not actually included in the document. When considering different classes of shares you must consider the tax consequences as they can be significant.

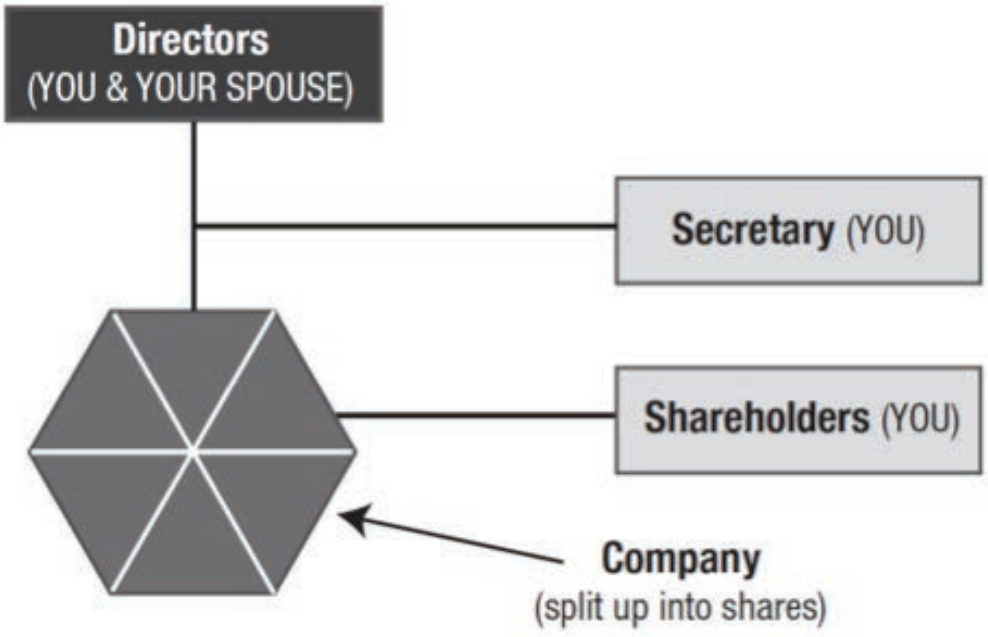
As previously said, if you use a company to own assets you still need to decide on who the shareholders will be. This is critical and will significantly change the advantages or disadvantages of using a company.

To help you understand this let’s look at ...

The structure of a company

A company consists of a number of shares and employs people called directors and a company secretary, who are responsible for running the company; it also has shareholders who own the company.

A TYPICAL COMPANY STRUCTURE



Directors control the day-to-day running of their company, make all the investment and borrowing decisions and are responsible for keeping the company solvent.

A company can have one or many directors. Large corporations often have a board of directors who decide on the company's future. However, in your property investment company, it is likely that you and your spouse will be the directors, which means you should understand that company directors assume serious obligations and are bound by the regulations set by ASIC (the Australian Security and Investments Commission). If you're planning on establishing a company, it's a good idea to discuss these issues with your lawyer and/or accountant to make sure you understand your obligations.

It is important to realise if your company falls into bankruptcy or gets sued, the directors can be held responsible. Therefore, directors of companies are wise to use asset protection precautions including insurance to protect themselves.

Note however that as a director you cannot insure yourself against wrong doings such as fraudulent dealings by a director or operating the company while insolvent or not paying any tax liabilities including corporate tax, GST and employee super guarantee.

The **Secretary** is responsible for the administration of the company. In a large organisation the secretary is engaged to ensure correspondence and records are maintained. In the case of the typical family run company, it is possible that you could be the director, secretary and only shareholder.

Shareholders: A company is split into portions called shares. There can be just one share or thousands of shares and people (or other entities) called shareholders own these. A shareholder can be a director (but doesn't have to be), and a majority shareholder can appoint a director to run the company. At the director's discretion, shareholders can receive a share in the profits of the company; this is known as a dividend.

How are companies taxed?

Companies lodge their own tax returns and pay tax at the company tax rate dependent on their (size (turnover) and once the company has paid its tax, shareholders receive part or all the remaining profit by way of dividends.

In the past all business paid a flat tax rate of 30% regardless of their turnover, but in recent years the government has been trying to legislate to lower company taxes.

From the 2016–17 income year, a lower rate of 27.5% applies to small businesses with an aggregated turnover less than $10 million. While there are currently a number of proposals to define which companies (defined by their activities) and at what income level companies will receive further reduced tax rates, there is currently no finite positioning on these proposals.

Is there anything else I should know about companies?

Yes, here are a few points:

- You can choose your company's name, as long as it is not identical to another company or is otherwise unacceptable.
- Your company will be issued with a unique Australian Company Number (ACN) that will be included in most company literature and business documents, e.g. invoices, receipts, business letterhead, cheques, etc.
- You cannot become a director of a company if (unless a court agrees), you are declared bankrupt and have not been discharged, or if you have been convicted of certain offences connected with the management of a company, a serious fraud, or certain other offences to do with the breach of duties of directors and insolvent trading. You are usually barred for five years after these convictions.
- Apart from a tax return, companies must lodge an annual return with ASIC.
- There is an annual ASIC fee for companies and this differs depending on the activities of the company i.e. a special purpose company used solely as the trustee of an SMSF
- Even though you are a shareholder in the company you have no rights to the specific assets of the company. Your shares, proportionally, give you the rights to any distributions of income by the company. The directors decide on the amount and timing of distributions and this can range from no distribution to 100%

As you can see, there's a lot to think about if you plan to use a company as part of your property investment business so here's my disclaimer again: you really need to see a tax professional before using a company structure.

Now we'll try not to confuse you even more as we discuss trusts in the next section.

WHAT IS A TRUST?

We've found most sophisticated investors own their assets though trusts, sometimes multiple trusts. This allows them to control their assets without actually owning the asset. A trust keeps their assets protected from lawsuits, provides them with flexibility in estate planning and passing their assets on to their children, and allows for the trust's income to be taxed at a preferential rate.

So what is a trust?

A trust is basically an agreement or promise. It is a concept at law when one or more people (called *Settlors*) transfer assets to other people or a company (called *Trustees*) to be held on trust and for the benefit and use of certain other individuals (called *Beneficiaries*).

History suggest that trusts originated in the 1200 when the knights went off to the crusades. "Who gets the castle if I die," and the concept of a trust was borne. The distinction between control and ownership was created.

In more modern times this has been expanded and different types of trusts have evolved but in essence they have moved from pure discretionary distributions to beneficiaries to fixed entitlements and then a combination of both.

Self Managed Super Funds are a trust but with specific rules with fixed entitlements to each member. Trust legislation is state based but overlayed by a federal tax system.

A trust (except superannuation trust) is not taxed but rather it is a pass-through vehicle where the beneficiaries are taxed on the amount they receive from the trust. The tax paid by the beneficiaries is at their marginal tax rate. If a trust does not distribute all its income, then it is taxed at the highest individual marginal tax rate i.e. 45% plus Medicare levy and other levies such as the Budget Repair Levy

Unlike a company, there is no legislative requirements that the trust must abide to (other than being legal) and as such you need to ensure the trust you use is prepared by someone who has a firm understanding of what you are wanting to achieve. A trust is an agreement and therefore has not specific requirements that must be included in the trust wording (trust deed).

However, there's no such thing as "one size fits all" when it comes to trusts – even though there are websites where you can buy generic trusts online.

Since a trust is just a set of words it is not a legal entity and needs a legal entity to sign documents and make decisions within the terms of the trust. This position of decision-making falls to the trustee - being either an individual or company. By the way… minor children cannot personally take on the responsibilities of a individual trustee or director in a trustee company.

The trustee has legal control; it's the trustee's name that appears on all legal documents, bank accounts, etc. The beneficiaries are not mentioned on these documents yet have beneficial ownership, meaning they are entitled to the assets and profits of the trust.

The basic function of a trust is to **separate control and ownership.**

The trustee has various obligations to hold the assets of the trust on behalf of the beneficiaries and must deal with the assets of the trust in accordance with the trust deed.

Now this is where it gets even more complicated, because a trust is not a separate legal entity at law (a concept many people have real difficulty understanding) – that's why it needs a trustee to run it, even though it must lodge its own tax return.

OK – to confuse you more…

Rental leases and other documents are signed by the trustee but on behalf of the trust and the trustee does not need to lodge its own tax return (only the annual ASIC return) if it is only acting as trustee, yet the trust has its own tax file number, bank account, GST registration (if required), stationary, accounts etc.

Go figure!

Sorry, but it gets even more confusing now because even though it lodges a tax return, a trust doesn't pay tax but can pass on its income to the trust beneficiaries. They then show the distributions from the trust in their own personal tax returns and pay the tax at their own tax rate.

If I haven't already lost you, let's further confound the issue by explaining that there are different types of trusts.

Before I get into this, the perceived complexity of trusts is maybe a reason they are often not recommended by many accountants and advisors but like any complex issue they are relatively easy to a professional in the area and they can take out much of the mystic and complexity. This is another reason to use specialists in your investment team.

A Discretionary or Family Trust

This is the most common form of trust, which allows families the flexibility to distribute income at their discretion to the various beneficiaries; i.e. family members or children.

Many investors use a family trust to hold their assets because it gives them the flexibility to distribute income to those beneficiaries who come under a lower personal tax rate than others. This can be varied from year to year to suit the different beneficiaries' situations. The assets in a trust continue on even after the death of a beneficiary, meaning the trust is a good structure for estate planning.

Metropole Wealth Advisory Pty Ltd, though its solicitors have access to a special discretionary trust, our **Family Security Trust™** which has some additional clauses, not found in most trusts, but which add additional protection and flexibility. There is an equivalent trust for operating a family business.

Unit Trusts

The beneficiaries of unit trusts hold a set number of units. These units are like shares in a company in that they confer specific rights to the unit holder. There can be various classes of units i.e. income only. The trustee has no discretion as to how it distributes income (which is very different to a discretionary trust). It just distributes in the same proportion as the units are held.

Unit trusts are useful when different parties want to own a defined share in a property or a business.

A unit trust can be used by individuals who require ownership in a trust but also require

an ability to offset any negative gearing (from a property held in the trust) against their individual tax liability.

They can also be used by multiple parties wanting to purchase a property together but require some flexibility for future changes to ownership percentages. Changes in ownership would trigger Capital Gains Tax but not stamp duty in most States.

Metropole Wealth Advisory Pty Ltd, though its solicitors have access to a special unit trust, our **Property Trust™ w**hich has some additional clauses, not found in most trusts, but which add additional protection and flexibility. There is an equivalent trust for operating a business with other parties.

Metropole Wealth Advisory Pty Ltd, though its solicitors have access to a special unit trust that in;

- NSW has access to the individual land tax threshold
- Victoria has access to the individual land tax threshold.

The **Property Trust™** has additional benefits in relation to asset protection. While an individual owns the units, they do not own trust assets and as such a receiver in bankruptcy who may have access to the units cannot force the sale of trust assets and the subsequent funds distributed to them as unit holder. This is different to you owning listed shares where the Trustee in bankruptcy can sell the shares and receive the cash.

Hybrid Trusts

A hybrid discretionary trust takes the best features of a discretionary (family) trust and a unit trust and mixes them together in the one entity to create a powerful and flexible tax planning solution. These have special benefits if established correctly for valid commercial purposes. You need to use an expert to set up these trusts on your behalf in order to ensure they comply with all the tax regulations as well as ATO operating requirements.

When using any trust or company structure you need to discuss this with your finance strategist so as to obtain the best loan option available.

In a hybrid trust an individual can borrow monies to invest in the trust and claim any negative gearing against personal tax liabilities, the same as in a unit trust. However, in addition the trust can have discretionary capacity. As previously identified the operation of the trust must comply with ATO rules.

As an example:

A hybrid trust can be of benefit when part of the purchase price is funded with after tax cash. In this scenario the borrowings used to buy units would be deductible in proportion to the ownership amount and the cash component would be treated as discretionary and that proportion (cash used to total purchase price) of income and capital could be distributed to any family member. As this portion was funded with cash there would be no negative gearing (hopefully the rent received is higher then operating expenses).

Metropole Wealth Advisory Pty Ltd, though its solicitors have access to a special hybrid trust, which has some additional clauses, not found in most trusts, but which add additional protection and flexibility.

Testamentary Trusts

Testamentary trusts are more tax effective than any other entity – however you have to die to get one – a bit of a sacrifice! This is a special sort of trust that only comes into being when a person who creates a will dies. It is in effect part of the will. This is an effective weapon to dampen the effects of Capital Gains Tax and stamp duty as it provides concessional tax treatment on distributions and is a useful estate-planning tool. They are especially useful in relation to managing asset protection, availability of assets in a relationship breakdown and the 66% tax impost on income distribution to minor children.

Main Residence Trust

Normally there is no Capital Gains Tax payable on any profits from the sale of the family home (Main Residence Exemption), if your home is owned in your individual names.

However, for people who are in very litigious industries, owning your home in your own name may not be appropriate and so a trust could be a better option.

Metropole Wealth advisory have access, through tax lawyers, to two different trust structures (dependent on specific circumstances) that would allow ownership in a trust and for the Main Residence Exception to still be available.

Of course as the home is used for personal usage there is no tax deduction on any interest on borrowed funds – but this is really the same as if it was owned in individual name.

One of these trusts would be beneficial if moving into an investment property purchased in a trust but is now required as the family home. The other is when purchasing from the onset in a trust a property to be used as the family home.

As always get specific advice prior to a purchase looking at both CGT and land tax implications before making any decision.

Some of the disadvantages of trusts include:

- They must be prepared by lawyers and require a corporate trustee to maximise their benefits; so they can be seen as a little expensive to establish. Costs must be weighed up against benefits. But having said that, in the long-term, this structure will save you lots of money, give asset protection, create flexibility and improve estate planning
- The same obligations and responsibilities apply to the trustee if a company as those of company directors.
- Many trusts only last 80 years. As part of a push to collect death taxes on assets the various governments required trusts to be created with an 80-year life span. The end date of a trust is referred to its vesting date. This means that the assets of the trusts will cease to be held in the trust, thus triggering capital gains tax. If the beneficiaries want to retain the assets, then stamp duty would be payable to change title reflecting the change of ownership.
- The myth is that this 80-year life is a blanket legislative requirement. This is certainly not the case and if you use a specialist lawyer to prepare the trust deed the trust does not need to stop at 80 years.

- In some states there could be a lower land tax threshold
- To get the full benefits of a trust we recommend the use of a company to act as trustee.

Some of the advantages of trusts include:

- Asset protection
- Flexibility
- Cash flow management
- Longevity
- Family security
- Business security
- Depending on property location some land tax benefits
- Ability to change control and not ownership which would trigger CGT and stamp duty
- Ability to consolidate different income streams
- Ability to park funds until require, thereby postponing maximum individual tax liabilities

Metropole Wealth Advisory has access to trusts of any type that have no Vesting Date as well as a Lineage Clause which protects assets to the direct descendants or the original beneficiaries. Many of our clients find significant advantages for their family and business to have these benefits.

Why you would consider using a trust?

Firstly, let us make it clear that you should never use a trust for the primary purpose of reducing your tax obligations. The ATO looks carefully at the reasons why people choose trusts as an investment owning vehicle and if it's for tax avoidance, then the tax could still be payable.

However, there are some legitimate and very valid reasons most sophisticated investors own nothing in their own name and everything in trusts. In more detail these include:

1. Asset protection

Our society is changing rapidly and we are becoming more litigious. Australia also has one of the world's highest concentration of lawyers per head of population. When trying to understand why part of the reason is the multitude of Australian laws which make it easier for plaintiffs to bring legal action. Also, when things are tough, it's easy to blame someone else and attempt to squeeze money out of them by dragging them into a legal battle.

You don't have to be in a high-risk occupation, like a doctor or lawyer to potentially be sued. Self-employed people, company directors and even property investors are at risk of getting sued and losing their hard-earned wealth. All it takes is one little mistake or accident, let alone a frivolous law suit. As an example, the directors or manager of a business takes on the responsibilities of Occupational Health and Safety and an incident could lead to personal litigation.

I've heard of property investors sued by their tenants because they tripped and hurt themselves on a loose corner of carpet,

contactors sue home owners for injuries that occurred while they were carrying out work on their property and employees sue their boss for all sorts of things.

And don't think being insured provides sufficient protection. We've all heard stories of insurance companies who have been happy to take their clients' insurance premiums for years, yet somehow manage to find a loophole in order to avoid paying out a claim when an incident occurs.

We're not suggesting you don't take out insurance, you must, however being insured is not a guarantee that you won't have to fork out money if you get sued; it's simply the first line of defence.

That's one of the many reasons why the wealthy own nothing in their own name; instead they control their assets by holding them in structures such as trusts.

Just in case you are wondering if a trust can't get sued – the answer is, well sort of.

As the trust is not a legal entity, it's the trustee that may be sued, but there is a simple answer to this; the trust (which you control) appoints a new trustee company to look after it and leaves the old trustee company, which is being sued, with no assets. Obviously if you get yourself into this type of situation, you should pay for smart legal advice to better understand your options.

Of course if rather than having a corporate trustee of your trust you had individual trustee, their assets could be at risk. This is why we recommend the use of a company trustee.

2. Estate planning

Many of us want to leave our assets to our children, but we really don't want the spouse that is no longer part of our family to take a portion of our hard-earned assets.

If you left your children a property each in their own name, this could get shared with the outlaw (is that what you call an in-law after the divorce?) by the family court. On the other hand, there are certain types of trusts that keep assets in the "family".

Metropole Wealth Advisory's **Family Security Trust™** contains additional clauses, not found in most trusts, which add additional protection and flexibility including a family lineage (direct descendants) clause.

3. Flexibility of income streaming

Owning your assets in a trust will allow you (the trustee) to distribute the trust income to the beneficiary who benefits the most.

Maybe your wife will take a few years maternity leave and not earn an income, while you continue earning a substantial income. If the assets you own in a trust produce income, you could distribute this to your wife, if using the appropriate trust, who would pay tax at a much lower rate than if you received the income. Remember, children can only receive $416 tax free and then pay tax at 66% with a sliding scale down to 45% (plus levies) unless they have worked for the money.

Just so you understand, a trust can make two types of distributions – income and capital gains. One of the advantages of owning assets in a trust is the income retains its character when it is distributed to beneficiaries.

What this means is, if a trust has interest income, trading income and a capital gain, each beneficiary who receives a distribution will receive a proportion of each type of income and the tax paid by the beneficiary must be calculated accordingly. Streaming between years may also provide good opportunities.

Obviously, the ability to stream income to taxpayers who have reduced income in a particular year, such as taking time off work on maternity leave, is a great tax advantage.

If in any year you do not need the funds or anticipate moving into a lower tax rate in future years you could distribute income (not capital gains) to a corporate beneficiary with a family trust as shareholder. This payment to the company will be taxed at the company tax rate and not your individual tax rate. In future years the company can pay a dividend and any additional tax will be due in the year of this distribution not in the earlier year. This strategy is particularly useful when looking at your asset protection and has an added benefit of postponing tax.

As previously advised the strategy could be used to distribute to accompany to purchase a property but please read the previous section of the advantages and disadvantages of using a company to purchase appreciating assets such as property.

4. Flexibility

Maybe you are not in the position to buy an investment property on your own at present, but you could if you bought the property with your sister or a friend.

Once again let's fast forward 10 years; your friend decides they want to sell up because they need their share of the money, but you'd like to keep the property. Your options would be to sell the property and pay Capital Gains Tax and stamp duty on another property, or buy your partner out and pay stamp duty on their half of the property at its new higher price.

If you had bought the property in an appropriate trust you could buy the relevant interest in the trust and trustee company or the units in the trust instead and not pay stamp duty on the property in some states, as the owner of the property (the trustee as the legal owner) does not change. The shares in the trustee company would have a nominal value and would not have increased from creation. Capital Gains Tax would still be triggered in the hands of the party "selling" but the saving in stamp duty could still be substantial. There would also be no need to change title. You may still be required to discuss with the bank holding the mortgage especially if the departing partner had given guarantees for the loan.

5. Trusts and tax benefits

One of the main benefits of owning assets in a trust is that the trust does not actually pay tax on any income it earns. Instead, it distributes the net income to the trust beneficiaries who then pay tax on their portion of the income at their own personal tax rate.

Even better – the trustee can distribute income in any way they see fit, provided distributions are made to people who qualify as beneficiaries. They do not have to make trust distributions in any particular proportion or in the same proportions as they did in previous years unless there are fixed entitlements.

So, who are these beneficiaries?

Well the beneficiaries of a trust are split into three main categories:

1. **Primary Beneficiaries** are the people for whom the trust was specifically created. This would usually include you, your spouse and your children.
2. A **General Class of Beneficiary** is basically anyone related to any of the primary beneficiaries. This could include the parents of any of the primary beneficiaries as well as their children, siblings, aunts, uncles, nieces and nephews. In fact, just about anyone else related by blood or marriage.
3. A **Tertiary Class of Beneficiary** includes any companies or other trusts in which a primary beneficiary of this trust owns an interest or has a relationship with. Furthermore, the deed can be written to also include charities. This can be beneficial if making donations to tax exempt bodies where you would not get a tax deduction. The trust makes a distribution pre-tax and the tax-exempt body receives it and pays no tax.

You are probably saying: “Well, this is all very interesting, but what does it mean to me?” What it means is a great deal of flexibility in tax planning, and here’s why …

At the end of each tax year, the trustee of the trust decides who will benefit from the net income of the trust. This is usually done in such a way as to distribute the income to those beneficiaries who will pay the least amount of tax.

For example, if Paula is an adult beneficiary of the trust and currently doesn’t work because she’s a stay at home mum and only receives income from a trust, she has the benefit of the tax-free threshold (currently $18,200) for the year. This means the trustee could distribute part of the family trust’s income to Paula who will receive income but may not have to pay tax if that amount is less than $18,200.

If Paula does actually get income from other sources in addition to distributions from the trust, all of the income will be taxed together at her marginal tax rate. This could still be lower than Joe, her husband’s tax rate, because he is a high-income earner.

Let’s look into this a bit further. Imagine a family trust has $50,000 of investment income to distribute and we have a family with mum, dad and three children, where the kids have no income of their own, dad earns $50,000 pa and mum earns $25,000 doing a part time job. We can do the following in a trust structure:

- Distribute $416 each to the children and pay no tax at all on this net income
- Distribute $15,000 to dad who would pay tax of 32.5 cents in the dollar

- Distribute up to another $12,000 to mum who would pay 19 cents in the dollar in tax
- Distribute the balance between mum and dad at that stage because they are on the same tax rate and pay 32.5 cents in the dollar
- As previously outlined, if funds are not needed in that period a distribution to a corporate beneficiary with a discretionary trust as shareholder could be made and only the company tax paid. When required it can be paid out and the receiver will pay any top up tax. This has deferred the tax on the current unneeded amount.

Just by doing this, the family has saved around $3,000 in tax, compared to what would have paid if dad had owned the investment in his name and owed the appropriate tax.

Now imagine if we do that for 10 years – we'd save over $30,000!! But wait (as they say in the ads), there's more.

Instead of distributing profit to mum and dad and paying tax at a higher rate, we might also be able to distribute some profit to:

- A retired relative and pay no tax at all (be careful of the Centrelink consequences, though, it may affect their pension entitlements)
- Any other relative who has less income than our primary beneficiaries and pays less tax
- When the children are over 18 and pay tax at adult rates, they could receive the first $18,200 tax free
- Another company that we own and only pay 30 cents or less in the dollar tax as described above.

What we have just done is saved even more money by paying less tax and in doing so, created more wealth for ourselves.

As you can see, owning your assets in a trust gives you the flexibility to pay tax at the lowest rate you can find amongst the various beneficiaries. Paying less tax means that you have more money available to reinvest into more assets, or to simply improve your lifestyle.

Another little trick is the distributions can be done in a way that does not see money actually having to go to the beneficiaries depending on circumstances. Of course, you need to discuss this, as well as all trust tax planning strategies, with your accountant.

Ensure you complete all necessary minutes and resolutions correctly and in line with ATO requirements. You must also ensure that any monies paid to family that is not cash flowed but distributed back to the trust (to then distribute as a non-taxable distribution) has the appropriate gift resolution or these relatives can at a future time demand the cash payments.

Additionally, if you sell an asset and derive a capital gain, the same principles apply. You just distribute the net capital gain to the beneficiary who will pay the lowest rate of tax after the 50% general Capital Gains Tax discount if the assets were purchased with the intention to keep and held for over 12 months.

6. Paying for expenses out of pre-tax income

As a wage earner, most of the things you buy come out of your post-tax income. For example if you are in the top marginal rate of 47.0% (including the Medicare levy), something that costs you $50 really costs you over $94 (that's how much you have to earn to be left with $50).

However, if you set up a trust to run your property investment business, the trust can pay for items that relate to your business out of pre-tax income. In the case of that $50 purchase, you have effectively saved yourself $44. Over time, this can really add up and leaves you with more money to reinvest.

Of course you can only claim for legitimate business expenses.

7. Land tax

Among other reasons, some investors hold their properties in a trust because in most states of Australia (other than NSW), a trust would be entitled to a separate land tax threshold. This could mean a significant saving in land tax (which is really a form of wealth tax), if the land tax thresholds were used intelligently.

For example, in Queensland each trust would be entitled to its own land tax threshold, meaning you don't pay land tax if the land value is under $350,000. The bottom line is if you owned a number of properties but held them in separate trusts with a separate trustee company, a significant amount of land tax could be saved.

8. Capital Gains Tax

Capital gains generated in a trust and distributed to individuals will still entitle the beneficiary to the 50% CGT discount on assets purchased with the intention to retain and owned over 12 months. but your accountant will be able to demonstrate how the intelligent use of a trust may allow you to save a heap of tax by streaming capital gains to the lowest taxed beneficiary payer.

Your accountant will also explain that there must be a commercial reason for doing this, rather than just minimising tax.

9. Distributing Income to the trust

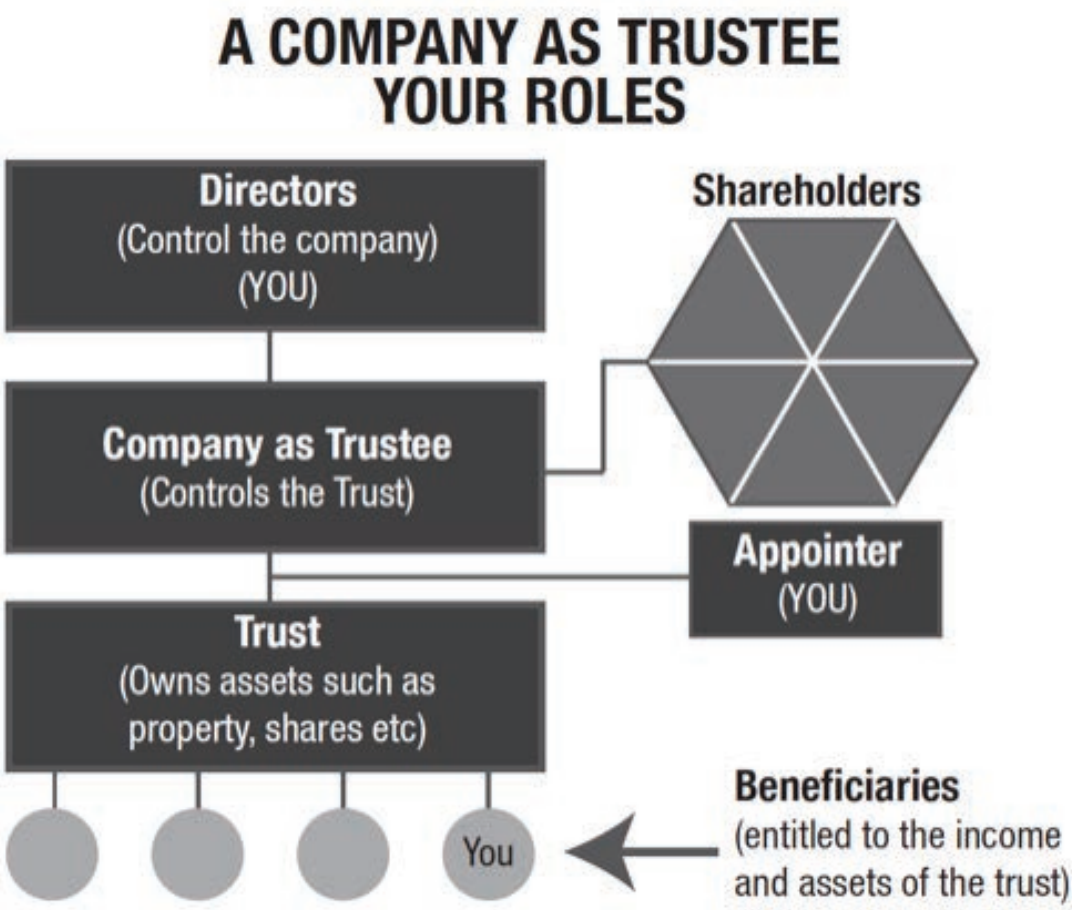
For business owners running the business through a discretionary trust, can distribute pre-tax profits to a different discretionary trust which may hold a negatively geared property. This allows pre-tax business income to be used to absorb negative gearing losses. This opportunity is not available to P.A.Y.G earners or businesses operating out of a company or as a sole trader.

Why use a company as trustee?

All trusts must have a trustee to manage their affairs.

This can be an individual – you for example, or a number of individuals – you and your spouse, or a company. If the trustee were a company then you would control the company by being a director and shareholder (as well as a beneficiary).

It would look something like this:



Structures like this are one way sophisticated investors protect and pass on their wealth from generation to generation, without tax implications.

Remember one reason people use trusts is for asset protection. Now if a trust gets sued, the entity the action is taken against is the Trustee. Let's see how this pans out and expands from earlier comments.

Imagine an injured tenant sues the trustee of the trust that owns one of your investment properties.

If you and your spouse are trustees, you could be joint and severely liable – in other words you could end up paying.

On the other hand, with a company as trustee, if the trust were sued, the appointor (controller of the trust) would dismiss the trustee who was being sued and appoint a new trustee. If the law suit is successful the equity in the trust could be at risk (subject to insurance) but not the assets of the directors of the trustee company.

If the trustee is a Pty Ltd company and the lawsuit continues, the trustee company owns no assets. It is only worth the $2 of its share capital. The assets are owned by the trust on behalf of the beneficiaries. In the end, the person suing you may not bother pursuing a court action but if so only the net assets of the trust are at risk which could be nil if an Equity Transfer Trust™ had been properly put in place.

Either way the directors would not be liable for this shortfall unless they were operating insolvent or acted fraudulently, or it was in relation to taxation monies.

In the next Section, we'll explain a bit more about family or discretionary trusts.

WHAT IS A DISCRETIONARY TRUST?

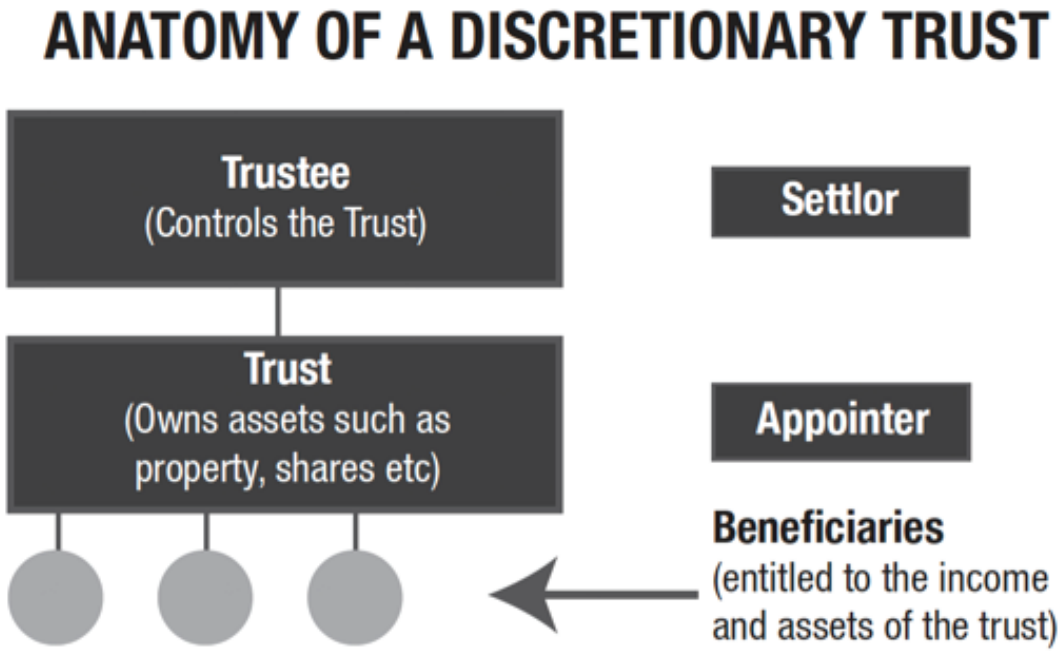
The most common trust used by investors is a discretionary trust often affectionately called a family trust.

Put simply, a family trust is a financial relationship where family members legally share wealth with other members of a family group. This can include grandparents, parents, children, grandchildren and even their children.

A trust can last and look after wealth for as many generations as are born for a period of 80 years from its inception. However, this 80-year period is not absolute if the right deed and associated documents are created.

Trusts are created by a gift of money by the sponsor called a **settlor,** and then further money is contributed to the trust as a loan or a gift, and is invested under the supervision of a **trustee**. When a trust makes income, or realises a capital profit, this is distributed to family members (the **beneficiaries**).

Let's have a look at a diagram of what a typical family trust would look like:



When you establish a trust, you receive a copy of the trust deed, which is a legal document that explains in detail what the trust can and cannot do. It also contains information, such as who is the trustee and who are the beneficiaries. All parties involved must sign the deed.

For it to be valid, the local Office of State Revenue must officially stamp it, which is normally organised by the accountant or solicitor who establish the trust on your behalf. The key players mentioned in the deed are:

The Settlor:

This is the person who established the trust. Remember one of the rules of a discretionary trust is that it must be set up by a "gift", which is normally only $10 to be held in trust for the primary beneficiaries.

Once settled, the settlor has no more involvement and has no legal obligations or responsibilities in the trust.

As the settlor is forbidden from benefitting from the trust, it would usually be your solicitor, accountant or a family friend, but you would not usually ask a family member as this could reduce your flexibility to make distributions later.

Be careful that your advisors do not invoice you for the $10 "gift" as it will no longer be a gift and you may jeopardise the integrity of the trust. For this reason, we suggest if at all possible to use a friend.

Once they have given the settlement sum, the settlor has no further role to play in the trust. If ever an action is taken against the trust the settlor would not be part of any legal claim as there only involvement was to give as a gift an amount to arrange for the trust to be set up and they have nothing to do with the operations of the trust.

Trustee

The trustee can be a single person, a group of people or a company that is responsible for making the day-to-day decisions on behalf of the trust. If it is a company, then you can control the trustee company by being the director and a shareholder.

The trustee does not own anything but makes all the decisions regarding the buying and selling of assets, the allocation of profits to the beneficiaries and the general spending and borrowing of money.

Remember, the assets and profits of a trust belong to neither the trustee nor the beneficiaries. They are held "in trust" and are being looked after, improved and added to for the future benefit of the beneficiaries.

If you change the directors of a trustee company no Capital Gains Tax and normally no stamp duty is payable if correctly implemented.

While a change of shareholders could trigger a CGT, as there is no increase in the trustee company share value, no tax would be triggered and again there is normally no stamp duty.

These changes effectively shift control and not ownership. This strategy could allow you to change control to say your children while you are still alive and trigger no taxes which would normally only occur with your death and subsequent move via your will.

Beneficiaries

The people who are to benefit from the assets and profits of the trust are known as beneficiaries.

A beneficiary can be a person, company, charity, religious organisation or even

another trust. In a discretionary or family trust, the beneficiaries are likely to be you, your spouse, your parents, your children, your siblings, your grandchildren, your nieces and nephews, any companies or trusts associated with any of these other beneficiaries, charities you name, etc.

But be careful - you should NOT distribute to your super fund (SMSF or other) unless it is within the rules of allowable contributions. Any non allowable distribution could create a 45% tax (plus levies) on the distribution and or the SMSF being deemed non-compliant which would have severe punitive consequences.

Before you say *"But I don't want my mother-in-law or Uncle Harry to have any of my assets"* – don't worry. None of these beneficiaries can demand anything from your discretionary trust, they are only on a list of potential beneficiaries and cannot demand to have a distribution made.

As a distribution can only be made to a nominated (by name or category) beneficiary, to allow for future flexibility of distributions, most trusts have a wide-ranging beneficiary clause, but it does not mean are of these "potential" beneficiaries are automatically entitled to a share of the profits. Only when the trustee decides (at their discretion) to pass the profits onto a beneficiary, does that person, or entity, receive anything.

Now a word of caution….

Recent State Legislation has widened the definition of is considered a Foreign Trust and this is particularly important for trusts holding property because Foreign Trusts have additional stamp duty and land tax imposts.

The wide definition now captures any one who could be a beneficiary, not someone who has or will receive a distribution. If that person is a non-resident or not an Australian citizen, then these taxes would apply.

As an example, if you have a sibling living overseas and married to a local then this would be captured under the foreigner definition and the additional taxes applied.

You may well ask "*How will the Government ever know?"* Good question, but there are many ways from a review when selling an asset or more simply the need for self-compliance. However, there is a relatively easy fix and you should consult your advisor, accountant or lawyer to get advice for both existing trusts and future trusts.

The Appointer

Is the most powerful person in the trust structure, which means it is important that you or your spouse control the trust by becoming the appointers. Your role would then be to appoint (hire) or dismiss (fire) the trustee of the trust. In simple terms, the appointor puts the trustee in place and the trustee distributes trust income in accordance with the trust deed.

You just can't make anyone the appointer.

Imagine the solicitor who sets up your trust is also the appointer. Now remember the trustee controls the trust assets, and let's further imagine that after many hard years of work the trust ends up owning $5 million in assets. An unscrupulous appointer (your old solicitor), could theoretically sack you as the trustee and take control of the trust assets by appointing a company they control as trustee instead. Don't believe this couldn't happen!

Never let anyone else have final control of your assets. If you must have another appointer or a joint appointer, it could be prudent to have a signed, but not dated, resignation as appointer safely tucked away – just in case.

The appointor is a personal position and is not capable of being taken over by say a receiver in bankruptcy who could not step in and vote in your place.

You should however resign as an appointor if it looks like you're heading for bankrupcy, if only to not aggravate the situation. You will obviously need to trust the remaining or new appointor.

How does the trustee decide who to give the trust income to?

As there are very strict A.T.O. requirements in identifying both income and payment needs for trusts, you must ensure any existing or new deeds comply.

The trust can allocate income or profits to any of its beneficiaries. The trust deed defines income and this needs to be carefully identified so as to meet both State Government and ATO requirements.

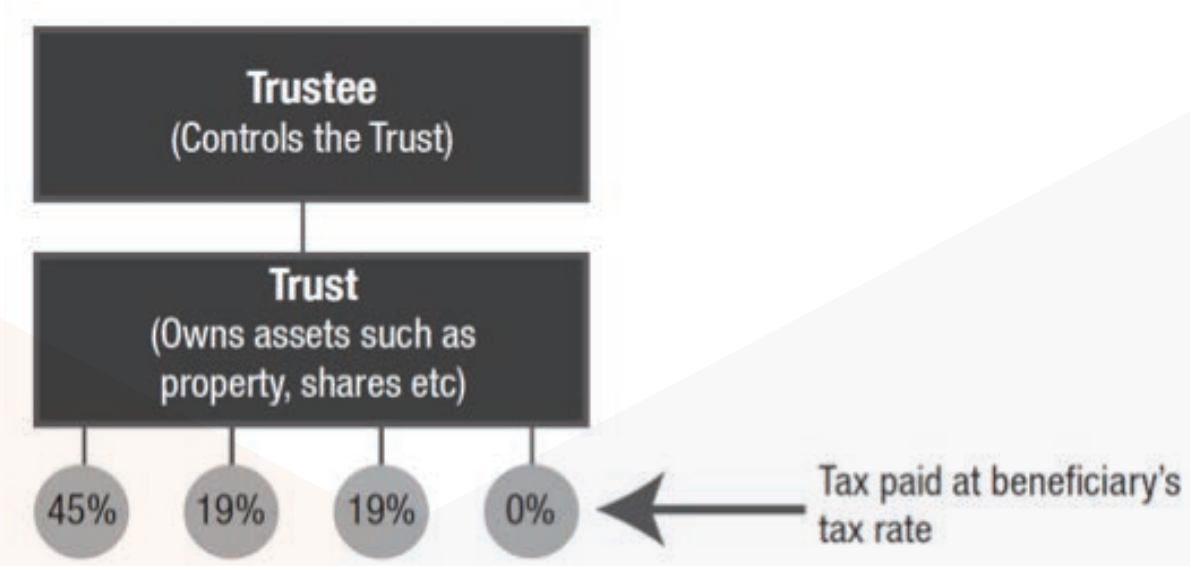
The trust does not pay any tax on its profit; the beneficiary pays this based on their total income, including any income from the trust.

One real benefit of owning assets in a trust is the trustee can choose to distribute its income to the lowest income earner, who would pay less tax than if it was given to the highest income earner.

In the following example Paul earns a good salary and pays tax at the top marginal rate of 45% plus Medicare. Collette, his wife, only works part-time and her marginal tax is only 19% plus Medicare, as is that for Renee their daughter who works part-time while studying. Robert is over 18 and a full-time student who doesn't work.

If the trust made an income of $10,000 it could be split and distributed to the lower income earners who would pay less tax than if it were distributed to Paul.

It's entirely the trustee's discretion as to how it distributes the income each year.



One more thing. If the trust distributes to a minor child (under age 18) and they have not actually worked for the money then minors get taxed at a penalty rate of 66% on a sliding scale down to 45% plus Medicare, to discourage distributions to minors.

As previously identified, a discretionary family trust can distribute income to other trusts or companies. If distributing to a structure with a loss, for example from say negatively geared property, then you need to ensure you meet the A.T.O requirements to ensure compliance. While this type of distribution is allowable, the A.T.O would require a family link between the two trusts and this is identified as a Family Trust Election which is a tick in the appropriate box on the tax return.

Some more things you should know about Trusts:

1. Vesting Date

Trusts normally identify a date at which time the trust ends (called vesting date). This is usually 80 years.

Now that may seem a long time away, but the consequences of vesting are significant, and it's an important point to consider if you're looking to leave a legacy to future generations.

When the trust vests (ends) and the assets are distributed to the beneficiaries, this will normally trigger a capital gains event and any beneficiary who may want to retain the assets of the trust will need to pay stamp duty. Both these taxes are based on current values not original purchase prices. It seems the original intention when introducing vesting dates many, many of years ago was as a form of death tax.

Now no one knows what the tax regulations will be in 80 years' time, but the cost to your grandchildren could be significant.

However, there are some trusts available which (under current legislation) have no vesting date, so if this is important to you ensure your trust has this facility.

Metropole Wealth Advisory's **Family Security Trust™** which contains some additional clauses, has been drafted with this in mind.

2. Lineage Clause

Given our desire to create wealth and pass it to the next generation, the last thing needed is for that wealth to be lost to a non-direct family member such as the ex-spouse of one of your children.

A special lineage clause inserted in the trust deed can help protect the trust's assets so they remain with the direct descendants of the original beneficiaries.

And since it should really be you who decides on who benefits from your hard work and smart investment decisions, it is important that your trust has a lineage clause.

Metropole Wealth Advisory Pty Ltd, though its solicitors have access to a special discretionary trust, our **Family Security Trust™** which has some additional clauses, not found in most trusts, but which add additional protection and flexibility through a family lineage clause.

LEGAL, BANKING & FINANCE

Once, after taking advice, you decide that setting up a discretionary trust or a Family Security Trust™ is right for you, then the next steps are:

1. **Determine the trustee**

We usually recommend setting up a new company to become the trustee of your trust. You can choose the name of your company (as long as no one else has already used the name) or we can provide one for you.

2. **Determine the beneficiaries**

Choosing your beneficiaries is an effective way to plan the distribution of your estate after your death. By identifying categories of people such as children, siblings etc., you do not need to change the trust deed every time you'd like to add someone new (such as a new grandchild) as a beneficiary.

You may name anyone as a beneficiary of a Family Trust, even if they are not a family member.

3. **Draft discretionary trust deed**

This step is where a customised trust deed should be drafted. Never buy a "one size fits all" deed. Remember there is a big difference between a legal document and a document that ensures your wishes are best served and is legal.

4. **Settling the trust**

A settlor, one who must sign the deed and 'settle' the trust property, creates the trust deed for the benefit of the beneficiaries.

This process requires the settlor to provide a small initial sum (usually $10) to the trustee. A settlor is typically unrelated to the beneficiaries and may be someone like a close friend and someone who will have no further involvement after the settlement.

5. **Signing the trust**

After the trust is signed by the settlor, the trustee(s) must hold a meeting agreeing their appointment as trustee(s) of the trust and accepting to be bound by the terms of the trust deed.

Some signatories need to be witnessed. The witness cannot be anyone party to the trust, someone who may benefit or a relative of such a person. A witness can be any person of legal age and rights and cannot be dragged into any dispute other than to affirm that they saw the person signing that they are witnessing to.

Some parts of the trust deed may require a witness from a designated group such as a Justice of the Peace and you must ensure the appropriate witness is used.

Double check that all sections of the trust deed are signed and by the appropriate person/s.

6. Stamp Duty

Stamp duty differs state by state and so applications are different within states and territories.

The costs of stamping your discretionary trust are currently as follows:

- WA – Nil
- ACT – Nil
- NSW – $500.00 (due 3 months of the date of the deed)
- NT – $20.00 (60 days of date of deed)
- QLD – Nil
- SA – Nil
- TAS – $20.00 (due 3 months of the date of the deed)
- VIC – $200.00 (due 30 days of the date of the deed)

Stamp duty is payable in the State where the trust deed is signed. Stamp duty is payable even if only one of the signing parties executes the deed where a tax is payable. This could lead to the situation where two people sign in Queensland (where no stamp duty is payable), but because one person signs in N.S.W., then the N.S.W. stamp duty would be payable.

It is recommended you sign two original trust deeds and stamp both. The cost of the duplicate stamping is normally only $10 in the states where a stamp duty is payable.

7. Apply for ABN and TFN

Upon establishment of the trust you must apply for:

- An **Australian Business Number** (ABN). All business need this to be able to claim GST expenses.
- A **Tax File Number** (TFN) - this is a unique number that assists the government in monitoring and reconciling personal income and taxes.

These tasks should be completed by your accountant.

8. Open a separate bank account

A bank account should be opened in name of the trustee ‘as a trustee for the trust.’

The first deposit into the account should be the settlement sum. This sum should be there before any other deposits or transactions are made.

When opening a bank account for the trust the bank requires a number of documents:

- A copy of the Trust Deed

This confirms that a valid trust exists and that stamp duty on the trust has been paid. The latter is evident by the stamp duty stamp on the cover or just inside the deed and is proof that the stamp duty has been paid and the deed is “official.” Some States no longer stamp the deed, but instead issue a certificate. You should ensure that you keep the stamp duty certificate with your deed.

- *A* **copy of the company registration**, if a company is the trustee.
- The normal **100 point ID proof** for setting up a bank account.

What should be the name of the bank account?

If you are Individual (personal) Trustees the account name will be something like: *John Smith & Mary Smith as Trustee for Smith Trust.*

Using our recommended structure using a corporate trustee the name of the account will be something like:

ABC Pty Ltd as Trustee for Smith Trust (abbreviated as ABC Pty Ltd AFT Smith Trust)

9. **Goods and Services Tax (GST)**

If your trust will own residential property, then you do not need to register for GST but if you intend buying commercial property or running a business (subject to minimum revenue expectations) you will need to register for GST.

Similarly, if you are building new residential property for resale then you also need to register for GST.

There could also be GST implications if you are purchasing property with the intention to sell.

GST is a very complex area so get advice prior to your purchase so as to include a GST in the feasibility study if required.

10. **Additional Requirements**

- **Soft Copies**
  You should make a soft copy of your final trust deed (including any stamp duty certificate) and of all minutes and resolutions and file these in a safe and everlasting place. A trust deed is a legal document and if lost it will be difficult to prove what was in it, especially to the A.T.O.

- **Minutes and Resolutions**
  Your accountant should complete:
  - The initial minutes and resolutions
  - Initial and subsequent unit set up including unit certificates and register
  - Arrange for any subsequent deed amendments if required

- **Taxation**
  Your accountant should also complete compliant and appropriate tax returns and year end minutes and resolutions ensuring distributions are in accordance with the trust deed and tax legislation and ATO requirements.

Some further steps to manage a discretionary trust:

Here are some of the ongoing management procedures for running your trust:

1. You will need to make a family trust election but only after discussing with your accountant. This involves identifying the individual members around whom the trust is centred. These are the people who will benefit from the income of the trust in the future but as important is required if you are moving income from one trust to another trust in a loss.

2. Ensure all investment decisions are in the best interests of the beneficiaries and comply with the trust deed.

3. Keep minutes and document all significant decisions and transactions.

4. Trustee companies must hold annual general meetings and meetings of directors and submit completed ASIC returns

5. Before June 30 of each year, hold a formal meeting and decide how trust income and profits will be distributed to beneficiaries.

6. Prepare annual accounts and lodge tax returns.

UNDERSTAND YOUR RESPONSIBILITIES

What does the Trustee do?

A trustee of your trust can be either an individual or company (our preferred option) has the day to day control and management of the trust. The trustee does not own the trust assets, but controls them on behalf of the beneficiaries and must exercise this control in the interests of the trust's beneficiaries.

What are the duties of trustees?

The responsibilities of a trustee are really duties to the beneficiaries. These include:

- The duty to preserve trust property;
- Duties to invest and insure the trust property;
- The duty to act in good faith;
- The duty of loyalty to beneficiaries;
- The duty to keep accounts and supply information;
- The duty to consider whether to exercise a discretion; and,
- The duty to act impartially between beneficiaries.
- The duty to operate the trust in line with the Trust Deed
- Ensure any new or required trust deed amendments are made. This can be due to either legislative changes at either the Federal or State level or in line with appointer, trustee, beneficiary or other interested parties' requests.

As you are likely to be the director of your trustee company, you must be aware of your significant responsibilities, so please consult your lawyer or accountant for specific advice as it relates to your circumstances.

If there is any litigation against the trust, then the trustee as legal owner would be sued and they would normally have indemnity in line with the trustee deed. Therefore, if the trustee is an individual their personal assets may be at risk.

However, with a company as trustee, the directors or shareholders are normally protected in line with normal company bankruptcy rules. With a company trustee, only the assets of the company (typically $2) would be at risk other than in some instances such as insolvency, fraud and tax liabilities where the directors would be liable.

Clearly the use of a company trustee increases asset protection for the individuals.

Another reason for using a company trustee is to make life easier in the event of an individual trustee passing or resigning. In these circumstances if the trustee is an individual then all title deeds need changing (bank approval), bank accounts would need changing as will other documents. If the trustee is a company and the individual director passes or resigns the title stay the same as do other records

Administratively changing trustee is relatively easy. However, if incorrectly implemented this could trigger a full stamp duty so ensure proper advice and implementation to avoid stamp duty.

What does the Appointor do?

The Appointor (sometimes called the Principal or Guardian) has, in fact, the most powerful role in a trust and should be carefully selected.

While the trustee is the one who decides what happens to the trust assets, funds and profits, it is the Appointor who has the power to change the trustee and appoint a new one.

The trust deed of a family trust should contain succession provisions for the appointors of the trust as well as a mechanism for the appointor to resign and appoint another person or entity in their stead. Further, the ability to have joint appointors can be a very important provision in many circumstances.

A well drafted trust deed will also enable the appointor to resign their position and appoint a replacement in their stead. This is particularly important for relationship breakdowns where one party may wish to continue the trust without the involvement of the other.

The deed should also provide that the appointor's position is vacated in the event of incapacity, bankruptcy and during a "family breakdown period".

What does the Settlor do?

The Settlor is someone who puts down a sum of money to start the trust, commonly $10. Once the trust is established, the Settlor has no further role, entitlements, rights or connection to the trust.

This $10 is a gift to commence (settle) the trust. It takes on the literal meaning of a gift i.e. you cannot give it yourself and the giver must not get back anything in return. Therefore the settlor can never be a beneficiary of the trust.

To be prudent we would also recommend that a relative or partner of someone who can benefit from the trust not be a settlor.

The $10 gift must be passed over. If in the form of a cheque it must be banked ie the settlor must lose possession of their gift.

Initial Beneficiaries

A beneficiary of trust is a person for whom a trust was created, and who receives the benefits of that trust.

When setting up your trust you need to identify the initial specific beneficiaries of your trust by name.

There is also a class of general beneficiaries that are not named but include your spouse, your children and remote descendants of such children; brothers, sisters, parents, children and remote descendants of such brothers, sisters and spouses of any of the foregoing. Also, companies and trusts associated with all these people, as well as approved charities and institutions are generally included in the trust deed as beneficiaries.

TRUST BORROWING AND PAYMENTS

How do I get money out of the trust?

One of the benefits of a family trust is that the trustee can distribute income earned by the trust in any way they see fit, provided distributions are made to people who qualify as beneficiaries.

They do not have to make trust distributions in any particular proportion or in the same proportions as they did in previous years.

A trust does not have to pay income tax on income that is distributed to the beneficiaries, but does have to pay tax on undistributed income.

The trustee is free to distribute trust income to as many beneficiaries as they wish, and in proportions that take best advantage of those beneficiaries' personal marginal tax rates. The beneficiaries then pay the tax on distributions made to them.

For example, if an adult beneficiary of the trust only receives income from a trust and has the benefit of the tax-free threshold for the year, the trustee could distribute part of the family trust's income to this person. The result is that the beneficiary will receive some income but may not have to pay tax if that amount is less than $18,000. If the distribution to the beneficiary exceeds his or her tax-free threshold, the excess amount will be taxed at the beneficiary's personal marginal tax rate.

Distributions received from a trust is not a special form of income, but instead forms part of a beneficiary's assessable income. If the beneficiary receives income from other sources in addition to distributions from the trust, all of the income will be taxed together.

Even if the beneficiary's income does exceed the tax-free threshold for a particular year, the rate of tax applied to the amount of the excess income over the tax-free threshold may be lower than for other beneficiaries because of the total income that these other beneficiaries already receive.

Undistributed income is taxed in the hands of the trustee at the top marginal tax rate, giving a strong incentive to family trusts to fully distribute the trust's income before the end of each financial year.

The trustee should also take care in relation to which beneficiaries are chosen to receive distributions, as penalty tax rates can apply to distributions made to minors (a 66% tax applicable in the child's hands on amounts above $416.)

You don't have to wait until the end of the financial year to distribute income to yourself (as a beneficiary.) You can withdraw cash or transfer the money into your own personal account any time you wish, but any interest on funds borrowed for personal spending will not be tax deductible.

It is important to keep a record of these money transfers and note whether they are a loan, a gift or a distribution of income and this will be accounted for at the end of the year in the trust's accounts and tax returns. The appropriate minutes and resolutions must be property made.

How do I pay myself from my trust?

Following on from above, here are a few concepts you'll need a basic understanding of:

1. **A Loan**
   If you're looking to take money out of your Trust, a loan account can be used to record the amounts taken. This will normally only be from after tax income that is in the trust. All pre tax income must be distributed or the highest individual marginal tax rates would apply.

   When you draw money as a loan, this sits on the balance sheet as money you owe to the trust. When the distributions are paid for the year, this reduces the balance owed back to the trust and you're loan account is left at the net amount (cash withdrawn – Distribution).

2. **Wages or a Salary**
   This is a simple way of paying out money from your trust. You essentially become an employee of your own trust.

   Paying a wage or salary while simple, also requires that superannuation is paid on the gross figure and also that PAYG withholding tax is taken out. This can be a disadvantage depending on your age and cash flow requirements.

3. **Directors' Fees**
   There is actually no real difference between taking a Directors' Fees instead of a salary apart from the name.

4. **Royalty or License Fee**
   A trust that uses another party Intellectual property can pay a fee to that party. Sometimes when using a company as the operating entity or ownership entity a fee for this and any management fees can be paid to another trust to help generate pre tax income in the receiving trust.

   Ensure any such payments are substantiated.

5. **Management Fee**
   If work is done by another entity for the trust then the paying trust can have an arrangement to pay as an expense such as a management fee.

6. **Distributions**
   Distributions are to a trust what dividends are to a company. They're the method by which you as the trustee of your trust allocate the profits to the beneficiaries.

7. **Overseas payments**
   It is important to note the different tax treatment for payments made to non-Australian tax residents. Different payment types will attract different tax treatments.

It is important to ensure that decisions about the distributions for an income year are made before the 30th of June of that year and are consistent with the clauses in the trust deed.

As you can see there are a number of ways of taking money from your trust and as these have varying tax consequences it is important to work with an adviser who has their finger on the pulse when it comes to distributions.

Can the trust apply for a loan?

Yes, trust can borrow money for business or investment purposes and while most banks are happy to lend to trusts:

- Directors of the trustee company will have to guarantee the loan
- In order to apply for a trust loan, you will need to provide identification for all trustees, directors of trustees and beneficiaries of the trust. A certified copy of the trust deed will also need to be included along with tax returns for the trust.
- Because they're more complicated than ordinary loans and often have unique legal issues attached, many lenders simply avoid trust home loans altogether.
- Some banks will treat it as a business loan and charge higher interest and additional fees because of the complexity and increased paperwork involved in the loan setup.
- Banks usually undertake a full credit assessment of the trust including examining the trust type and deed, the structure of the loan applied for, the credit file of the trust and the beneficiaries.
- Trust assets will be required as security for the loan.

Taxation and Banking (Using Trusts)

- As with all loans, you will need to ensure proper purpose of any loan to enable tax deductibility of interest expenses.
- When using a fixed trust, the bank will only approve the loan to the trustee or the trust and to shift the tax liability down to the unit holder for tax purposes, you will need to complete other paperwork. While you should always try and get the loan in the unit holders name, if it is not possible then you will need what is called an *On Loan Agreement* to ensure appropriate tax treatment. The A.T.O. generally understands that the banks, being concerned for their own security, will lend as they see fit and so they generally accept the need for this additional paperwork.
- As the property value increase, subject to bank approval, you can refinance and extract the equity for other uses such as a buffer, deposits and costs on other property purchases or to use as lifestyle cash flow. The loan purpose will determine tax deductibility of interest.

Can the trust apply for a credit card?

Yes it can, although the trustees are most likely required to personally guarantee the credit.

If using a credit card, you can spend money for personal expenses and expenses relating to the trust. Expenses relating to the trust will be tax deductible to the trust, however money spent on personal items will be considered income (distributions) for you as a beneficiary.

We suggest you do not mix personal and investment spending on your trust credit card - only use for trust related business.

STEPS REQUIRED TO PURCHASE A PROPERTY IN A TRUST

When it comes to purchasing property through in a trust structure, many people get a little confused with the process, so here are some tips.

It is too late to set up your ownership structures after the contract to purchase a property has exchanged, so you need to get advice and if appropriate set up your new ownership structure before you start your property search and definitely before you place an offer on a property and Contracts are exchanged.

In other words:

1. Your trustee company must be set up and registered before the trust is set up (as you must nominate an existing entity as trustee at the time of setting up your trust, but these can be done simultaneously.
2. The trust documents must be then completed, executed and stamped (if required) before you start using it.
3. You should also set up the trust bank account, register tax file number, ABN and if required GST registration before signing any contracts

The Money and Paper Trail

We have already recommend you open a bank account for the trust in the name of the trustee as trustee for XXX Family Trust and you should, if possible pay all costs including the deposit for the purchase of your property from this bank account.

You may need to firstly bank the deposit into this account prior to paying the vendor. This leave a clear paper trail to prove that the "XXX Trust" paid for the property.

Once you own your new investment property all rents should be paid into your trust bank account and expenses and loan repayments should be made from this account.

What name goes on the contract?

If you are purchasing a property where a trust is the buyer (beneficial owner), it is the trustee's name that must go on the contract of sale (the trustee company is registered as the legal owner) and you will need to sign the contract as a director of the trustee company.

In other words, the contract will show the legal owner as *ABC Pty Ltd* and does include the name of the trust.

In general, you will usually also need to sign a personal guarantee ensuring that the trustee company will fulfil its obligations under the contract of sale.

In some States (currently Queensland) it may be required to also identify the trust name. While the trust name does not appear on title the State Government documents the trust, so as to refer to in case you change trustee and it is easier to prove a trust relationship.

Land Tax

It is your responsibility to register for Land Tax when purchasing a property, or if usage of the property changes – e.g. from principle home to investment.

Unfortunately, many State Government systems cannot distinguish whether the trustee company is acting as a company in its own right or as a trustee of a trust which ultimately owns the property, so their default is to treat it as if the company owns the property by applying the company land tax threshold and rates.

If you are audited and or are selling and needing a land tax clearance certificate the trust will be identified, and penalties including interest will apply.

It is therefore recommended to register your Trust as owner of the property, even if the land value is within the State threshold, as you may forget to register when the land value increase to a point were land tax is levied.

Many States either have a lower Land Tax free threshold and or higher tax rates for Land Tax for properties held in a trust.

Recent changes in some states call for a higher rate of land tax for foreign trusts which hold property and have discretionary distribution powers. What has emerged from these rules is that where Australian discretionary trusts have the ability to distribute to a non-resident beneficiary, (typically, a distant relative or spouse (wide definition) of a relative who lives overseas), this may also result in the Australian discretionary trust paying the additional land tax.

Purchase Stamp Duty

When using a trust to purchase assets such as property the normal stamp duty will be payable by the trust on the purchase.

There is no stamp duty surcharge for buying property in a trust, however recent changes in some states call for a higher rate of stamp duty for foreign purchasers and for non-resident trusts.

What has emerged from these rules is that where Australian discretionary trusts have the ability to distribute to a non-resident beneficiary, (typically, a distant relative or spouse (wide definition) of the relative who lives overseas), this may also result in the Australian discretionary trust paying the additional stamp duty on the purchase of a residential property.

Negative Gearing

Within a discretionary trust, if your investment property has more expenses than income, in other words if it is negatively geared, these losses can't be taken out of the trust or distributed like income can, which means you can't offset these losses against your personal income.

You don't lose the losses, they just get quarantined in the trust to be used in future years and get offset against future income.

If you are using a special Property Trust™ any negative gearing is effectively streamed to you and therefore against any PAYG tax liabilities.

Conclusion

Hopefully this Trustee Companion has helped demystify this thing called "A Trust" a little for you.

Of course, the team at Metropole Wealth Advisory is always here to help answer any of your questions.

As this is general information, to find out how this could apply to your circumstances, please get in touch:

Please call us on 1300 20 30 30

Or access www.metropole.com.au