

# understanding family trusts

## INTRODUCTION

A discretionary family trust is an asset ownership structure setup to hold family assets or run a family business. This type of ownership structure has several benefits and is usually established to distribute investment income to family members in a tax effective manner, protect assets and to pass wealth to future generations.

There are many advantages with holding assets within a family trust, however, this type of ownership structure can be complex, and hence, it is important to understand the functions and characteristics of this structure.

## WHAT IS A TRUST?

A trust is an ownership structure in which assets are held by a trustee on behalf of designated beneficiaries. There are various components that make up a trust and each of these are explained below.

## APPOINTOR

The appointor has ultimate control over a trust. He or she is able to appoint and remove trustees at his or her discretion.

## TRUSTEE

The trustee is the legal owner of trust property and responsible for the day to day operations of a trust. They manage assets on behalf of beneficiaries and cannot use trust assets for personal benefit.

## TRUST DEED

The trust deed details the rules and boundaries for operating the trust. Amongst other things, it lists the beneficiaries, outlines what investments the trust can acquire and details the procedure to appoint and remove trustees.

## TRUST ASSETS

These are the assets held within the trust and can include any type of asset such as property, shares, fixed interest, artwork, motor vehicles, etc.

## BENEFICIARIES

Beneficiaries can either be individuals or a corporate and are ultimately the ones who may benefit from trust assets. The income generated within the trust can generally only be distributed to nominated beneficiaries and may include the trustee if they are also a beneficiary. Trust capital can also be distributed to beneficiaries.

## TYPES OF FAMILY TRUSTS

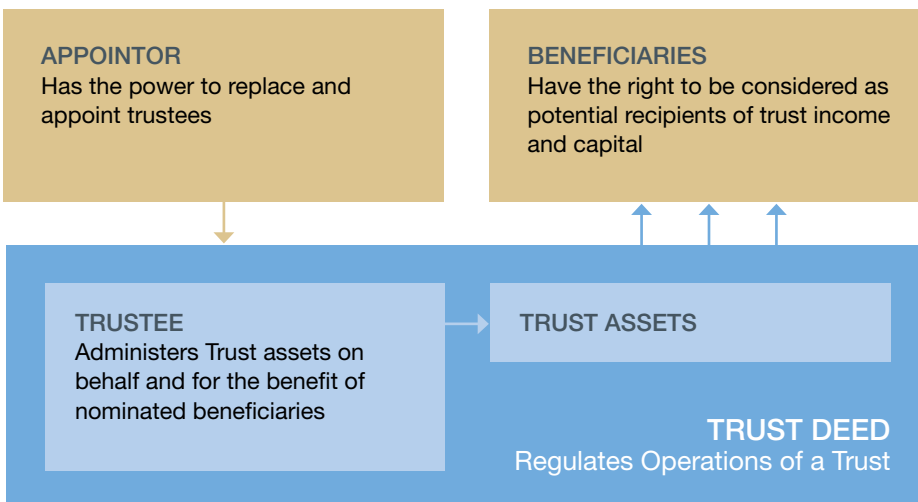
There are various types of family trusts, but for optimal flexibility, a family trust is usually set up as a discretionary family trust. A discretionary trust is one where the trustee has complete discretion over how income or capital is distributed and the amount each beneficiary will receive.

## CASE STUDY

Helen establishes a trust with Brian appointed as the trustee. Rachel and Kelly are the nominated beneficiaries. The trust deed requires that any income generated by the trust be distributed to the beneficiaries in equal share.

As trustee, Brian is required to administer the assets of the trust for the benefit of Rachel and Kelly and not for Helen or himself.

At the end of the financial year, the trust has generated income of \$1,000. In accordance with the trust deed, Brian distributes \$500 each to both Rachel and Kelly. Brian and Helen cannot receive a distribution as they are not beneficiaries.



This article by Frank Camilleri (above), National Technical Manager.

## WHO SHOULD USE A FAMILY TRUST FOR INCOME DISTRIBUTION?

Family trusts are useful for families with considerable assets who have:

- Non-working spouse or dependant adult children on low incomes.
- Dependant handicapped children.
- Both members of a couple that are on high incomes.

## WHAT ARE THE BENEFITS OF A DISCRETIONARY FAMILY TRUST?

### ASSET PROTECTION

A properly constructed family trust can operate to protect assets from potential creditors and litigants and may also protect assets in the event of a beneficiary suffering marital breakdown. This protection is not absolute, however, as assets held within a family trust are not legally owned by the beneficiary (they are legally owned and controlled by the trustee on behalf of the beneficiaries), these assets are normally not available to creditors.

### FLEXIBILITY WITH INCOME DISTRIBUTIONS

Discretionary family trusts provide trustees with the flexibility to adjust distributions according to the needs and circumstances of family members. This is advantageous as income and capital can be distributed to beneficiaries in the most tax-effective manner and may increase the net return on trust assets. It is important to be aware however, that if distributions are made outside of the family group, those distributions will be taxed at the highest marginal tax rate.

### CASE STUDY (SEE TABLE BELOW)

Mark and Jean have two children, Andrew and Christine who are age 18 and 14 respectively. Mark earns \$100,000 p.a and Jean earns \$45,000 p.a. They have \$2 million in assets generating gross investment income of \$100,000 p.a.

Firstly let's assume that Mark and Jean own the assets jointly in their own name. Taking into consideration the tax they would each pay, their combined net income would be approximately \$174,775 (based on the 2010/11 tax rates including Medicare).

Alternatively, by establishing a family trust, Andrew and Christine can be included as beneficiaries. This enables

investment income to be spread across all beneficiaries in the most tax-effective manner. As Andrew is 18 years of age, any distribution he receives is taxed at adult tax rates, however any income received by Christine is subject to the higher tax rates applicable to minors (although she is still entitled to up to \$3,300 tax free).

In this situation, one distribution strategy would be to allocate \$35,000 of the income to Jean, \$61,700 to Andrew and \$3,300 to Christine. This would increase the family's combined income by 12,275 to \$187,050

Distributing trust income in a tax efficient manner results in the family's combined income increasing by \$12,275 (\$187,050—\$174,775).

### FAMILY CORPORATE BENEFICIARY

Family trust beneficiaries do not need to be individuals but may also include a family company. The benefit of having a family corporate beneficiary is that distributions made to a company is taxed at a flat rate of 30% compared to personal marginal tax rates. During periods where family members are on marginal tax rates higher than 30%, a family trust could allocate income to a corporate beneficiary to reduce the amount of tax paid.

### RETENTION OF FUNDS WITHIN THE FAMILY TRUST

While income from a family trust needs to be distributed annually for tax purposes, this does not mean that funds need to be transferred out of the trust. They can be retained within the trust and accumulated over time. A beneficiary who retains their share of the distribution within the trust, may at anytime demand payment of these funds.

It should be noted that where the trust has a corporate beneficiary, there may be adverse consequences if distributions are not transferred to the corporate beneficiary.

Option 1: Assets Owned Jointly by Mark and Jean		Option 2: Assets Owned in Trust with all Family Members as Beneficiaries	
Income - Mark Inc. \$50,000 investment income	\$150,000	Income - Mark No trust distribution	\$100,000
Income - Jean Inc. \$50,000 investment income	\$95,000	Income - Jean Including \$35,000 trust distribution	\$80,000
Income - Andrew	Nil	Income - Andrew Including \$61,700 trust distribution	\$61,700
Income - Christine	Nil	Income - Christine Including \$3,300 trust distribution	\$3,300
<b>Total Family Income</b>	<b>\$245,000</b>	<b>Total Family Income</b>	<b>\$245,000</b>
Less Family Tax Liability	\$70,225	Less Family Tax Liability	\$57,950
<b>Net Family Income</b>	<b>\$174,775</b>	<b>Net Family Income</b>	<b>\$187,050</b>



# Shadforth Financial Group

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