Discretionary Trusts

Discretionary trusts are a commonly used tool in the organisation of a person's affairs and can also be a useful estate planning tool if properly established. When used effectively, discretionary trusts can offer a number of advantages in terms of asset protection and tax efficiency.

What is a discretionary trust?

A trust is a form of legal relationship primarily between two parties; the trustee and the beneficiary. The trustee has legal ownership of the trust property and is bound by an equitable obligation to use the property for the benefit of the beneficiaries.

A discretionary trust is one type of trust. They are most often used in family situations to distribute income and capital between family members. Under a discretionary trust, the trustee has the discretion as to which of the beneficiaries will receive a distribution of income or capital from the trust. The beneficiaries of the trust have no legal right to demand a distribution, merely a right to be considered by the trustee.

The trust is established by the settlor of the trust and the trustee executing a trust deed. The trust deed sets out the rights and obligations of the trustee and the beneficiaries.

The parties

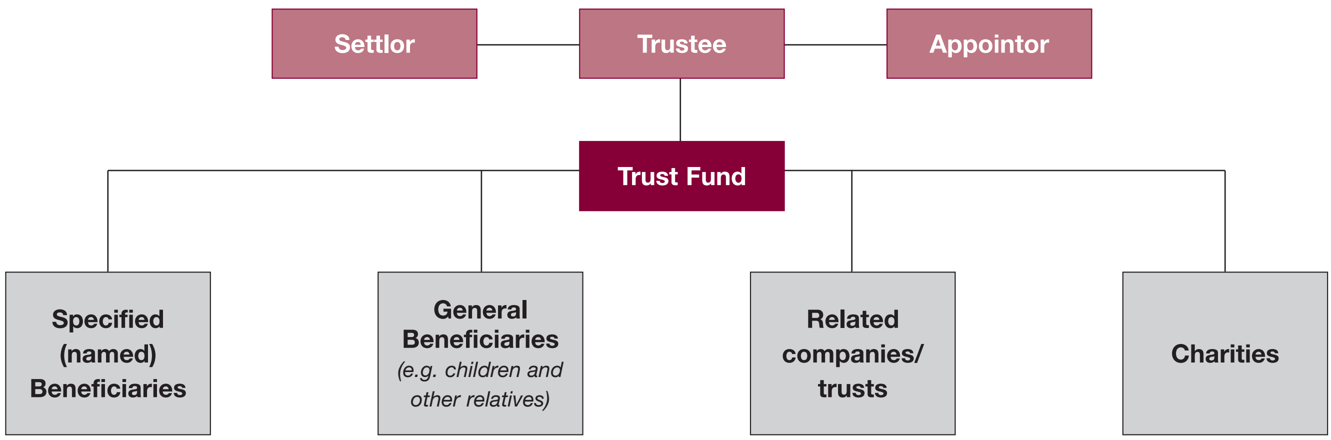
Settlor The settlor of the trust is the person who gifts a sum of money or other assets called the settlement sum to the trustee to hold it on trust for the beneficiaries. The settlor is normally an unrelated third party and is someone who is not and will not be a beneficiary under the terms of the trust.

Trustee In practice, the trustee is responsible for the management of the trust and for making distributions of income and capital. The trustee can either be a company or an individual and it is possible for multiple trustees to be appointed.

Appointor The appointor ultimately controls the trust because it has the power to add or remove the trustee of the trust. The appointor can either be a company or an individual and it is possible for the power of appointment to be shared between two or more appointors.

Beneficiaries The beneficiaries are those people or entities who are entitled to receive distributions of income and capital from the trust. The beneficiaries of a discretionary trust can be named individuals or classes of individuals as well as companies and trusts associated with those individuals. Usually discretionary trusts are established to benefit members of a particular family so the beneficiaries will be defined with reference to the family (e.g., husband and wife and their descendants). It is also common for trusts to include charities as eligible beneficiaries.

Structure of a Discretionary Trust



Advantages of discretionary trusts

- Discretionary trusts are flexible. Each year the trustee can decide which beneficiaries will receive a distribution. This allows income to be split between beneficiaries to minimise the tax payable.
- Different types of income can be distributed to different beneficiaries. For example, if the trust makes a substantial capital gain in one year, then the collective tax liability of the beneficiaries can be reduced by distributing the capital gain to a beneficiary who has capital losses which can be used to reduce the CGT liability which would otherwise accrue on the capital gain distributed from the trust.
- Discretionary trusts also offer asset protection for 'at risk' beneficiaries (e.g. company directors, doctors, lawyers, accountants, medical professionals) who prefer not to own assets personally. For example, upon the bankruptcy of a beneficiary, the trustee can decide that income distributions to the bankrupt from the trust should cease. Because the assets of the trust are not legally owned by the beneficiary, the creditors of a bankrupt beneficiary are not entitled to the trust income. However, the discretionary trusts will not afford protection to a bankrupt beneficiary if assets were transferred into the trust for the purpose of avoiding the claims of the bankrupt's creditors.
- A properly structured discretionary trust can also offer protection if a beneficiary is going through a divorce. The discretionary trust will allow the beneficiary to benefit from assets within the trust but because they are not legally owned by the beneficiary (the trustee is the legal owner), they are not able to be included by the family court in any court ordered property settlement. However, it is important to note the court may include the assets in the trust as a "resource" of the beneficiary in deciding the split of divisible assets between the couple.
- A properly structured discretionary trust can also enable the succession of assets from one generation to the next.

Disadvantages of discretionary trusts

When deciding whether a discretionary trust is a suitable structure for you, consideration should be given to the following issues:

- Tax losses are trapped in discretionary trusts and cannot be distributed to beneficiaries. Instead, losses can in most cases be carried forward within the trust and offset against the future income of the trust.
- The assets of a discretionary trust must be sufficient to justify the expense of administering the trust. For example, accounts will need to be prepared and maintained and a tax return will need to be lodged each year.
- If a beneficiary of the trust is a pensioner, then care needs to be taken to ensure the beneficiary's pension eligibility is not jeopardised.
- Administration of the trust may require a level of cooperation between family members who may share the role of trustee of the trust. This could potentially lead to disharmony.

Reviewing your trust deed

If you already have an established discretionary trust, then it is important that you have the trust deed periodically reviewed. Changes to taxation law can mean that trust deeds become quickly outdated. For example, some older trust deeds may not allow different types of income to be identified and distributed to different beneficiaries. This may mean your trust is not able to make distributions to beneficiaries in the most tax effective manner possible.

Review of existing trust deeds is an essential component of estate planning and should be done at the same time as your Will is prepared. Many people hold their most substantial assets in trust structures, so it is important you consider who you want to control your trust when you pass and to make the necessary arrangements as part of your overall estate planning.

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