N.E. RENTON AND ROD CALDWELL

FAMILY TRUSTS

5TH EDITION • FULLY UPDATED

A Plain English Guide for **Australian Families**

With practical information on:

- The pros and cons of family trusts
- Different types of trusts
- Drawing up a trust deed
- Estate planning and philanthropic trusts
- How family trusts and their beneficiaries are taxed
- Winding up a trust

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ABOUT THE AUTHORS

Nick Renton (1931–2010)

Nick was a consulting actuary, commercial arbitrator, company director and writer. Born in 1931, he qualified as a Fellow of the Faculty of Actuaries in 1957 and was a Fellow of the Institute of Actuaries of Australia. He was a licensed investment advisor and qualified commercial arbitrator. In 1975 he was elected a Fellow of the Securities Institute of Australia for his services to the industry.

After 15 years as Principal Officer of a life insurance company Nick became the first Executive Director of the Life Offices' Association of Australia in 1975. He was Executive Director of the Life Insurance Federation of Australia from its formation in 1979 until 1986. In those capacities he acted as the official spokesperson for the life insurance industry.

Nick went on to work as an independent business consultant to leading stockbrokers, insurance companies, employer organisations, government agencies and others. He served on the boards of several financial institutions and was in great demand as a speaker at seminars and conferences.

He was the founder and first president of the Australian Shareholders' Association, federal president of the Australian Society of Security Analysts and Victorian chairman of the Commercial Law Association of Australia.

Nick Renton was published widely in Australia and the United States. He wrote on more topics than any other Australian author, including more than 60 published books covering shares, property, managed investments, taxation, wills, good writing, public relations, the internet and the Australian economy, as well as numerous papers to professional bodies. He also published nearly 600 articles in newspapers and financial journals, presented papers to conferences of linguists and contributed to a textbook on journalism.

In 1992 he was awarded the prestigious H M Jackson Memorial Prize for two of his works, *Understanding Dividend Imputation* and *The Retirement Handbook*. In 1995 he received the Ken Millar Award for his best-selling *Understanding the Stock Exchange* and his highly controversial *Company Directors: Masters or Servants?* Nick died in August 2010.

Rod Caldwell

This revision is co-authored by Rod Caldwell. Rod is a tax accountant with postgraduate qualifications in taxation. He spent 15 years with the Australian Taxation Office (ATO), where he was a tax advisor in a centre of excellence, recognised by CPA Australia as a tax specialist and awarded Fellow status. He left the ATO in 2005 to try his hand at teaching. Rod has lectured and tutored in taxation and management accounting at a number of Australian universities including Monash University, University of Western Australia and Edith Cowan University, as well as teaching business studies at the diploma and advanced diploma level at a number of TAFE colleges in Western Australia. His first book was published by Wrightbooks in 2004. He currently has five books in print.

Additional resources for this and other texts are available from Rod's website, www.tpabusiness.com.au. The author is also happy to answer any questions you may have in relation to any of his texts at rod@tpabusiness.com.au. Answers to all questions raised will be published in the Q and A section of the website.

PREFACE

Despite the technical-sounding title, this is not a textbook for legal practitioners. Neither is it a guide for the super-rich. Rather, it is a plain English guide for the average Australian family.

This very practical work will help ordinary families and small business proprietors to understand the concepts underlying a very useful legal device — the family trust. The book will help them to arrange their financial affairs in better ways, taking into account current conditions and their own particular circumstances.

Very little written on this important subject has been directed towards families at large. This is surprising, as there are about half a million family trusts in Australia today and that number is growing steadily. *Family Trusts*, *5th edition*, explores a number of fundamental questions raised by those involved in family trusts and sets out to answer them comprehensively. These real-life queries and case studies will help to flesh out this important subject. The topics covered include the qualifications needed by trustees, hybrid trusts, the risks of borrowing by trustees, non-resident beneficiaries, minutes of meetings, resettlements, the protection of assets against creditors, bankruptcy and divorce.

Many people toy with the idea of setting up education funds for newborn children or go in for other 'Mickey Mouse' savings schemes. The idea of making adequate financial provision for the family is a common enough theme. A few distinct elements are involved here:

⇒ Firstly, money has to be put aside for this objective. In recent times many commentators have drawn attention to the fact that Australians are not saving enough.

⇒ Secondly, any money put aside has to be invested wisely. This involves putting together a suitable portfolio of investments and avoiding vehicles that impose excessive charges.

⇒ Thirdly — and this is the subject of the present book — an appropriate legal structure needs to be employed.

Families with even modest assets need to devote some energy to managing them properly. All too often their main effort is directed towards minimising income tax and/or maximising current or potential social security entitlements. The main goal, however, should be to maximise the family's wealth, to protect its assets and to provide financial security for its members. For reasons elaborated later in this book, setting up a suitable family trust can be one significant ingredient in such a strategy.

This book will help:

⇒ those thinking about restructuring their financial affairs and looking into setting up a family trust as one option

⇒ current and potential beneficiaries under a trust who want to know what their rights are

⇒ current trustees who want to understand their duties and powers

- ⇒ those charged with choosing new trustees who wish to consider what qualities such appointees should have
- ⇒ persons invited to become trustees of existing funds who wish to know exactly what their obligations would be.

The chapters that follow will explain in lay terms what the legal device known as a trust, whose origins date back to Tudor England, means in this modern age. They will alert readers to both the advantages and the disadvantages of setting up a family trust. After all, many trusts are intended to last a long time and involve a permanent alienation of assets. And even if they start off in a fairly small way, they can grow over time to handle quite large sums. So getting things right in the first place is critically important.

The book also comments on some sociological aspects; for example, the fact that family trusts, although collectively the custodians of many billions of dollars' worth of assets, are completely unregulated. Equally surprising is the absence of any voluntary industry body to help trustees by providing educational resources and lobbying on behalf of trusts in relation to legal changes.

The information and alternative strategies set out in this practical book will equip families to discuss this important subject more intelligently with their solicitors, accountants, financial planners and other professional advisors.

CHAPTER 1

THE CONCEPT OF A TRUST

Just what is a family trust, and who should have one? The advantages and disadvantages of using a family trust structure are elaborated later in the text, but it may help to set out some background information first, starting with an analogy.

The concept of a *will* is better known than that of a trust. A will is a legal instrument that allows a person to nominate individuals who are to inherit that person's assets after his or her death. The will can also impose conditions in regard to any such legacies or bequests. The person making the will is called the *testator* and the persons receiving the assets are known as the *beneficiaries*. The document also names an *executor* to handle the paperwork involved in distributing the assets in accordance with the law and with the testator's wishes as formally set out in the will.

Commonly such documents appoint a person to be both 'the executor of my will and the trustee of my estate'. Technically, the executor's role is to convert the assets to cash as required, and also to pay the debts of the deceased estate; the trustee role follows on from that. However, in practice 'executor and trustee' is always viewed as a single appointment covering all facets. On the testator's death, the executor becomes the legal owner of the assets but holds them only temporarily *in trust* for the beneficiaries.

Trust is a technical legal term that refers to a relationship based on confidence under which property is held by and formally vested in its legal owner, who is known as the *trustee*, but on behalf of other parties who are entitled to the fruits of that ownership—the *beneficiaries* (or *objects*) of the trust.

Types of trusts

Many different types of trust exist at law. For example, superannuation funds normally involve trust arrangements, as do many charities. Solicitors, stockbrokers and other professionals use trust accounts in respect of clients' money. Other types of trust commonly encountered include cash management trusts and unit trusts generally. A *purpose trust* can be set up for the furtherance of a specific objective rather than for the benefit of one or more specific persons.

There are also *statutory trusts* created by law, for example in relation to persons unable to look after their own affairs, and there are even bare trusts, where the sole obligation of the trustee is to convey property to beneficiaries when required to do so.

A trust involves a legal obligation to hold property for the benefit of others. A donor who makes a gift by means of a trust is able to stipulate how the property concerned is to be used; such control would not apply in the case of an outright gift. This ability to impose obligations on the recipient of property makes the trust format attractive to donors who want the greatest degree of assurance that their gifts will be used as they intended.

For the purposes of this book, an *inter vivos* (*between living people*) family trust can be thought of as a similar arrangement to that provided by a will, except that it is established by a trust deed and allows a person to pass on his or her assets while still alive. It is also possible to set up a family trust by will rather than by deed. Such a trust, known as a *testamentary trust*, comes into existence only on the death of the testator rather than immediately a trust deed is executed. This aspect is further discussed later in the book.

Either way, the beneficiaries of such a trust are normally family members of the person instigating the arrangement. Often some selected charities are named as additional beneficiaries. The term *family trust* is purely descriptive rather than legal. A family trust can be, but does not have to be, a unit trust.

In the case of an inter vivos trust the legal document, which roughly corresponds to the will, is called a *trust deed*, or sometimes a *deed of settlement* or *indenture*. Beneficiaries can be named individually, but more commonly in a modern deed they are named as a broad category, such as 'all the children of John Henry Smith'—or, in practice, some more elaborate version of this.

The deed can also spell out appropriate rules or conditions. The whole arrangement is really just an elaborate means of making a gift with, if desired, certain strings attached. The conditions can deal with virtually anything, but the courts do not enforce conditions that seek to impose illegal conduct or are even against public policy.

A trust created by deed is sometimes referred to as an *express trust* or a *declared trust*, as distinct from a *constructive* or *implied trust*. The latter is established by conduct—for example, by opening a bank account with the words 'as trustee for' in its name.

Beneficiaries

With a deceased estate, the normal (although not invariable) objective is that the executor should distribute the assets to the beneficiaries as quickly as possible and then disappear from the scene. With a family trust, in contrast, the intention is usually that the arrangement should last for a long time.

The class of beneficiaries can extend to children yet to be born and to marital partners yet to be acquired. Because of this it is usually best not to specify beneficiaries individually by name unless there is a particular reason for doing so. Indeed, in some cases naming a person as a beneficiary in a trust deed might raise false expectations.

Numerous variations on beneficiaries are possible. For example, siblings, cousins, half-brothers and half-sisters, stepchildren, adopted children, de facto spouses, ex-spouses, same-sex partners and grandparents can all be included or excluded, according to individual preference.

Beneficiaries do not have to be natural persons; so, for example, family companies, other family trusts, or unconnected charities and non-profit organisations (preferably ones that have been incorporated) can also be included. Pets cannot be beneficiaries, however, although a person willing to look after a pet could be appointed instead!

It is usually desirable also to name an entity—for example, a favourite charity—as the *residuary* or *default* beneficiary, in order to cover the possibility that none of the other potential beneficiaries is alive when assets are to be distributed.

Trust deed

Generally speaking, a trust deed cannot have retrospective effect. However, a deed could be used in order to confirm in writing the details of a trust that had previously been set up verbally. A trust deed would normally name the initial trustee or trustees and set out the mechanism for filling casual vacancies and for making any additional appointments required.

Legal entity aspects

It should be noted that a trust is not a legal entity, although the goods and services tax legislation discussed later treats trusts as entities for purposes of that legislation. Unlike a company, a trust estate—or, for that matter, a partnership—is not a separate 'person' in the eyes of the law. (A trust estate, for this purpose, includes a deceased estate.)

This principle extends to the taxation of trusts, which is discussed in detail in the chapters devoted to taxation. From time to time changes to the basis of taxing trusts are mooted. This possibility should always be borne in mind and some flexibility built into the trust deed.

The parties to a trust

A typical trust arrangement involves a trust fund and the following parties:

⇒ The *settlor* (occasionally called the *grantor* or *founder*) legally creates the trust by executing (signing) the trust deed and by feeding in the initial assets of the trust fund (often only a nominal amount of cash sufficient to satisfy a legal fiction).

⇒ The *trustee* administers the trust in accordance with the deed and the law and (very often) exercises various discretionary powers. The duties and powers of a trustee are discussed in greater detail overleaf.

⇒ The *beneficiaries* are the individuals who are entitled to receive income and capital payments from the trust fund, again in accordance with the rules set out in the deed. Persons can be named as beneficiaries for income only or for *corpus* (capital) only, or for both.

⇒ In the case of some trusts, an *appointor* can be given the power to remove trustees, appoint additional and replacement trustees, and nominate a successor as appointor.

⇒ Alternatively, in the case of some trusts a *guardian* or *protector* can, for example, be given:

- ✧ a power of veto over certain types of transactions
- ✧ a power of veto over proposed amendments to the trust deed
- ✧ a power to remove or appoint trustees
- ✧ a right to be consulted in relation to certain investments
- ✧ a power to act as arbitrator or mediator in the event of certain disputes
- ✧ a power to nominate a successor as guardian or protector.

The trustee owes a fiduciary duty to both the settlor and the beneficiaries. The trustee also acts as the legal owner of the assets constituting the trust fund, in much the same way as an executor acts as the legal owner of the assets in a deceased estate. Thus, for example, bonds, shares, land and motor vehicles would be registered in the name of the trustee. Bank accounts and the like would similarly be opened and operated in the name of the trustee.

There is no restriction on the types of assets that may be held by the trust if so authorised by the deed, but the assets would not 'belong' to the trustee in the ordinary sense of the word. They would merely be held 'in trust' for (that is, for the benefit of) the various beneficiaries.

Such assets can be described as being in a *trust estate* instead of in a *deceased estate*, and the whole arrangement can be described as an *inter vivos* or *living trust*. *Note:* This should not be confused with what is loosely referred to as a *living* *will*—a document dealing with the desired withdrawal of life-sustaining medical procedures in certain circumstances.

Wills and trusts compared

The idea behind a will is better understood than the idea behind a trust deed, probably only because people know they will die one day and must therefore make a will. In both wills and trusts, varying percentages can be allotted to different beneficiaries, although naturally these percentages should add up to 100 per cent. Assets and income can be distributed separately; so, for example, under a husband's will all the income could go to his wife during her lifetime and the capital (the corpus) could go to the children of the family in equal shares on her death. This is a common scenario, often with a mirror provision in the wife's will. A similar approach could theoretically be used in a trust deed, but it would be more usual to set up a *discretionary trust* instead.

A variation of this theme is possible whereby the original owners retain an interest in their assets. Thus a *charitable remainder trust* could be set up with, say, the donors receiving the income for life and one or more charities acquiring the assets on the death of the last surviving donor.

In all of these circumstances the recipients of the income are called the life tenants and those entitled to the capital are known as the *reversioners* or *remaindermen*. In theory, the settlor of a trust could also be one of the beneficiaries of that trust. However, such a combination would probably lack credibility and could open to challenge the genuine nature of the entire trust arrangement. It is therefore better to name as settlor someone who is not related to the family and who is not otherwise involved with it.

Such an approach may also be a useful form of insurance against adverse changes to the law in the future. For similar reasons it is probably better for the settlor not to be a trustee either. (Some further aspects of this theme are mentioned in chapter 2.) However, the class of beneficiaries can also include the trustee. The legal ownership of the property that the trustee holds in order to carry out the trust always remains separate from any interest the trustee may have as a beneficiary.

This separation of legal and beneficial ownership is an essential feature of all trusts. In fact, a trust automatically comes to an end if the legal and beneficial interests merge—as, for example, when the sole trustee and the sole remaining beneficiary of a trust are the same person and there is no possibility of further persons becoming beneficiaries (for instance, by being born or reaching a certain age). Persons who declare that some particular property owned by them is to be held by them in trust for someone else become both settlors and trustees.

An arrangement that might suit all concerned could involve two friends setting up unconnected family trusts for their respective families (not necessarily at the same time). One person could act as the settlor of the fund for which the friend is the trustee, with the roles being reversed for the other fund.

Some comparisons between wills and trusts are summarised in appendix A.

Other preliminary points

This book is a general guide for lay readers to assist them to better understand the ramifications of family trusts and their advantages and disadvantages. It deliberately avoids the numerous footnotes to obscure cases that are a feature of textbooks aimed at legal practitioners. However, it is not a substitute for seeking out proper professional advice tailored to the reader's individual circumstances. It should also be borne in mind that the law relating to trusts and particularly to the taxation of trusts and their beneficiaries changes from time to time.

In Australia, trust law and a number of important taxes affecting trusts—notably stamp duties and land tax—are the province of state governments. As in many other walks of life, the laws in this area, while similar, are not uniform throughout the country. However, income tax (including capital gains tax) is a function of Commonwealth legislation.

To a large extent, trust law is not found in statutes but rather is part of the 'common law' of the state concerned—the past decisions of the superior courts and the precedents these create. The origins of trust law were actually in 'equity', the body of rules formulated by the English Court of Chancery to supplement the rules, procedures and deficiencies of the common law.

For reasons discussed later, most modern family trusts are discretionary. This means that those who are to receive benefits from the trust each year and the amount each person is to receive are not specified in the deed itself. Instead, a discretion to make the decisions in regard to these and associated matters is vested in the trustee. Naturally, the recipients have to fit the *categories* defined in the deed and likewise the total payouts must be within the limits imposed by the deed.

A family trust can be a powerful yet flexible vehicle. Of course, the success of any family trust depends on far more than just its legal structure and the personality of the trustee. It must have adequate funds under management and these must be invested wisely.

Terminology

For convenience, words such as *executor* and *trustee* are often used in this book in the singular. However, as explained later, it is possible—perhaps even desirable—for a number of individuals to act collectively as the trustee of a trust. The word *beneficiary* is, in line with custom, loosely used both for a person actually in receipt of a distribution from a trust fund and for someone (strictly speaking, a *discretionary beneficiary*) who is merely a member of a defined category of persons all of whom are contingently entitled to receive such distributions.

CHAPTER 2

MODERN FAMILY TRUSTS—ADVANTAGES AND DISADVANTAGES

Before looking at family trusts in today's conditions a brief scan of the past may help shed light on some of the legal niceties. Trusts are very versatile creations of the law. They date back to sixteenth-century England. Wealthy property owners in those days frequently wanted to 'settle' some of their lands on their children as a mechanism to avoid the payment of death duties. A *deed of settlement* was a convenient device for such a purpose in that distant era.

This ancient procedure, enshrined in the common law of England (and of Australia), has with the help of some legal fictions been adapted to modern needs. The trust has become an essential part of life in those countries that use it, although somewhat surprisingly it has no legal counterpart in many other countries.

Fundamentals of family trusts

The general provisions of a deed of settlement traditionally usually included a right for the trustee to accept further assets into the trust fund, beyond those transferred at the time of the original settlement.

Death duties and gift duties no longer apply in this country. However, when death duties were originally introduced into Australia at state and federal levels (under various names) a series of anti-avoidance provisions were also enacted. For example, gifts made by a person shortly before death were, for duty purposes, treated as not having been made at all: duty was levied on the total of the actual estate and the notional estate represented by the value of those gifts and of certain other items. In addition, a gift duty regime was imposed to complement the death duty regime. Similarly, assets that were settled on beneficiaries could be caught if the settlor retained some connection with the trust fund, such as the ability to exercise some control over it. For that reason it became customary to have an outsider act as the settlor, with the initial settlement involving only a nominal sum such as ten dollars.

This procedure is still widely used today, probably because it also serves to avoid some complications both under the *Income Tax Assessment Act 1936* and in relation to state stamp duty. In particular, it helps to ensure that no additionally created documents could ever be regarded as further settlements by the original settlor.

The more substantial asset transfers envisaged by the family in setting up the arrangement are then made as gifts to the trust fund by, or as loans from, persons other than the settlor. Under the former provisions such gifts could be caught for death duty if the donor's death took place within a write-back period such as three years, but otherwise they were safe from such imposts. Furthermore, and most importantly, any capital appreciation from the date of transfer was naturally regarded as having been made within the trust fund itself and so did not adversely affect the size of the notional estate. The gift amount was effectively frozen for all time.

Typically the settlor making the nominal initial payment is a friend or relative of the father of the family. The father places some of his personal assets into the family trust for the benefit of his wife and children (and possibly also of other beneficiaries, including charities). He might also wish to act either as the sole trustee or as one of several trustees, or to have a corresponding role on the board of a company acting as the trustee.

Under the death duties regime described previously it was best to have as beneficiaries members of the father's family (and other parties, if desired) but not the father himself. As death duties have since been abolished throughout Australia, this particular limitation is unnecessary today, except possibly as a precaution against some future reintroduction.

A typical family trust

As explained previously, the operations of a trust are always governed by its own trust deed. The precise wording in such a document will be influenced by the solicitor drafting it and by the wishes of those giving the necessary instructions, so theoretically every deed may be different.

However, a typical discretionary family trust would involve the following steps:

- ⇒ At commencement the settlor would settle certain property on the trustee, to be held in trust for the beneficiaries.
- ⇒ The settlor would also execute (sign) the trust deed. In the type of family trust under discussion, this would be a formal one-off transaction in an artificially contrived but perfectly legal arrangement, with the settlor then having no further part to play and no ongoing involvement.
- ⇒ The duration of the arrangement would be long term, very often a maximum of 80 years, a period used to ensure compliance with a legal principle known as the *rule against perpetuities* (discussed on p. 15).
- ⇒ The detailed conditions of the trust would be set out in the trust deed.

⇒ From time to time other gifts would be made to the trustee, to be held in trust for the beneficiaries in the same way as the initial amount.

⇒ During the life of the trust the trustee would pay out the income of the trust fund to beneficiaries designated by the trustee in proportions determined by the trustee.

⇒ For tax reasons such distributions would normally be made each financial year, although the deed would also permit the accumulation of some or all of the income within the trust fund.

⇒ During the life of the trust the trustee could also, if desired, pay out some or all of the capital of the trust fund to beneficiaries designated by the trustee in proportions determined by the trustee.

⇒ At the termination date the trustee would pay out the net balance of the trust fund after all liabilities had been satisfied (this balance comprising both capital and any accumulated income) to beneficiaries designated by the trustee in proportions determined by the trustee.

⇒ Various specific powers would be vested in the trustee, including the power to invest, to lend and to borrow.

⇒ Someone would be given the power to remove or replace the trustee and/or to make additional appointments.

There would normally also be a limited power to amend the deed, but not with respect to rights that had already crystallised. Amendments would probably involve legal fees and could also be costly in terms of stamp duty and/or capital gains tax.

Default provisions need to be set out to cover the possibility that the trustee does not make the expected discretionary decisions. In the case of income each year, the default mechanism can be to accumulate the income (although this involves a tax liability for the trustee). In the case of capital and of undistributed income at termination, a possible formula is a distribution to *primary beneficiaries* as tenants-in-common in equal shares; primary beneficiaries are defined in the trust deed as, say, the parents and their children, as distinct from more distant relatives. Again, one or more residuary beneficiaries need to be named to cover the possibility that all the primary beneficiaries are dead.

The rule against perpetuities

The rule against perpetuities is ancient. It was originally based on a policy of not tying up feudal land and preventing its free alienation. Settlements in breach of this rule would be void, but the solicitor preparing the deed would normally ensure that it was a valid document. It is, of course, possible that the rule will one day be abolished by statute. On the other hand, 80 years is about two and a half generations, and it may be unwise to assume that what is sensible at the beginning of such a lengthy period will still be appropriate at its end.

Non-discretionary trusts

A family trust can also be set up as a non-discretionary trust (sometimes also referred to as a *fixed trust*, a *specific trust* or a *rigid trust*). For such vehicles the deed itself would spell out the specific beneficiaries and their entitlements. The role of the trustee would then be mainly administrative.

The initial amount contributed by the settlor, together with any subsequent sums accepted by the trustee under the deed, is called the *settled sum*. This is similar to the subscribed capital of a company. While for tax reasons it is usual for income beneficiaries to receive an absolute interest, for capital beneficiaries contingent interests are quite feasible. The contingency could, for example, be reaching a specified age or getting married.

Note: The term *fixed trust* is also used in a quite different sense in relation to unit trusts, where it refers to trusts with share portfolios involving a certain number of specified listed companies in fixed proportions.

Source of funds

The capital an individual puts into a family trust can come from a number of different sources, such as:

- ⇒ an existing portfolio of investments
- ⇒ an inheritance
- ⇒ lump-sum superannuation
- ⇒ lump-sum damages
- ⇒ gambling winnings
- ⇒ the proceeds from the sale of a home or from downsizing to a smaller home
- ⇒ the proceeds from the sale of a farm or business
- ⇒ ongoing savings from personal exertion income
- ⇒ ongoing savings from investment income.

Such capital can be put into the trust either by way of a gift or as a loan. Both methods can have social security implications, as discussed later in the book, and loans of this kind would often be interest-free.

Gifts versus loans

The advantages of using loan funds include the following:

- ⇒ There is greater flexibility for the provider of the funds, should circumstances change causing that provider to need any of the funds again. This flexibility will be even more relevant if that person is not among the class of persons eligible to be beneficiaries of the trust.
- ⇒ The provider of the funds is still able to include them in his or her personal net assets. This may be important