A guide to discretionary trusts

A discretionary trust is a structure that holds assets on behalf of Beneficiaries of the trust, removing individual legal ownership of those assets.

A discretionary trust may be created to hold a family's investments (a family trust) or as the result of a Will (a testamentary trust).

To understand the potential benefits of a discretionary trust you first have to understand how a discretionary trust is set up and how it operates.

Setting up a discretionary trust

A **Settlor** (usually a family friend, lawyer or accountant) establishes the trust with an initial deposit of a small amount of money. The Settlor can't be a Beneficiary of the trust.

A **Trustee** is appointed to manage the trust's assets and has full discretion about who benefits, and to what extent, under the trust. Although the Trustee is the legal owner of the trust assets, they only hold the assets for the trust's beneficiaries and they have a duty to act in the best interests of the trust Beneficiaries.

The Settlor and Trustee determine the terms and conditions of the trust by way of a **trust deed**. The trust deed sets out the duties and powers of the Trustee and names the Beneficiaries or class of Beneficiaries. There are many other duties imposed on the Trustee by law.

Beneficiaries are those entitled to receive a distribution from the trust. They can be individuals, companies and other trusts.

The **Appointor** has underlying control of the trust and the power to change the Trustee. A discretionary trust does not need to have an Appointor.

Potential benefits of a discretionary trust

Efficient tax planning for families

The Trustee decides how income from the trust is distributed among Beneficiaries so the income can be directed to Beneficiaries in a way that can lessen the overall tax liability.

Case study

Let's say, for example, you were a sole trader earning $200,000 for the year. If all the profits are assessable to you, you'd pay $67,850 in tax.*

If you were to run your business through a discretionary trust, you could spread the distribution of business profits between you and other members of your family as follows:

- You receive a salary of $75,000 a year so you only pay tax in a lower tax bracket (tax payable $17,475).
- The trust makes a tax-deductible super contribution of $25,000 for you (tax payable $3,750 in super).
- The trust pays $75,000 to your spouse (tax payable $17,475).
- The remaining $25,000 is paid to your 18-year-old daughter who has no other income (tax payable $1,875 with Low Income Tax Offset).

In this example, using a discretionary trust you could potentially save $27,275 in tax and transfer $21,250 (after tax) into super where it's protected if your business goes broke.

* for the 2009/2010 tax year

Effective estate planning

Setting up a testamentary trust through a Will has advantages both for the person making the Will and the nominated Beneficiaries.

As we've shown, the discretionary trust can be used effectively to distribute income among family members. Income from a testamentary trust can be similarly distributed to minimise the tax burden on the Beneficiaries of the Will.

Assets receive the same protection under a testamentary trust, so it's a way to ensure your assets remain within the family after you're gone.

The tax concessions don't just apply to income and capital gains derived by the trust from inherited assets – they also apply to any income and capital gains derived from assets bought with money reinvested from the original inherited assets.

Protecting your assets

Because under a discretionary trust, Beneficiaries do not legally own the assets, the assets can potentially be better protected from any legal action involving Beneficiaries or misuse of those assets.

So, for example, if a family member is likely to go bankrupt or get divorced, their assets may be protected from claims by creditors or their ex-spouse. The family member can still potentially receive income from the trust.

How are discretionary trusts taxed?

Any income you receive as a Beneficiary of a discretionary trust is assessable to you. The income will hold its character as if it was directly earned by you outside the trust relationship (for example, dividend income). This income may include franking credits and grossed-up capital gains or losses.

Generally, the Trustee doesn't pay tax on the income earned by the trust, as long as it is allocated to adult resident beneficiaries. Any trust income not allocated to Beneficiaries is taxed at the maximum marginal tax rate. The trust may also pay tax on behalf of minor beneficiaries and non-resident beneficiaries.

Discretionary trusts can also set up a family company as a Beneficiary and take advantage of the 30% company tax rate for distributions from the trust.

Things you should consider

This publication doesn't take into account your personal objectives, financial situation or needs. It's important for you to consider these matters before making any financial decision and we recommend you seek help from a financial adviser.

securitor

SE11074-0410bt