The operation of a trust can be very confusing, especially for those with no experience with them. In order to run a trust correctly, you need to have an understanding of the basics surrounding a trust.

To assist you, we have compiled this document for you. It is by no means an exhaustive discussion of how a trust operates, or how the various laws apply to trusts. Basically this is our simplistic view on how a trust operates.

The parties involved in a trust

There are 4 main parties in most trusts. These are:

- The settlor;
- The appointor;
- The trustee(s); and
- The beneficiaries.

The settlor

This is the person who establishes the trust. Generally this person is required to be independent of the other parties in the trust, which is often why your accountant will be the settlor. The settlor generally has no control of the trust, or rights in the trust.

The appointor

The appointer is the person who appoints the trustee of the trust (see below for a discussion on the trustee). This person can be the trustee (i.e. you appoint yourself) if so desired. Generally this person also has the power to remove a trustee and appoint another one.

The trustee(s)

A trust is not an entity like a company – it is merely a number of parties (the main 4 mentioned above) coming together agreeing to hold property or other assets ***in trust*** for the beneficiaries.

One of its major uses is to separate control from ownership. A “trust fund” often used by wealthy parents for their children is one example. Until the child is eligible, those assets are controlled by a separate party (the trustee) for the benefit of the child (the beneficiary). The trustee makes all the decisions relating to those assets, but gets none of the benefits.

Any assets within your trust will be held in the name of the trustee (which may be yourself, a relative, your company, or any combination that the appointor nominates). As such, it is not uncommon to have more than one trustee.

Whenever you want to purchase an asset in the trust, the title of that asset must be in the name of the trustee(s).

The beneficiaries

As you may have guessed from the above discussion, the beneficiaries are the ones that receive the benefits from the assets that are within the trust. This includes any income generated from those assets.

There can be more than one beneficiary to a trust, and in most cases, to ensure the trust is “dynamic”, a trust will be set up with primary and secondary beneficiaries.

Primary beneficiaries

These beneficiaries would be the individuals that the trust is primarily set up to benefit. It could be just yourself, your children, or anyone you choose.

Secondary beneficiaries

This is where the trust becomes dynamic. It is common for a trust to state that any person, company, or other entity related to the primary beneficiaries, whether in existence now or not can be a beneficiary.

For example, a married couple with no kids may set up a trust with the above setup. If they have a child in 5 years, that child is automatically included as a beneficiary upon birth. If they decide to set up a company at a later date, that company will also automatically be a beneficiary.

The trust deed

The trustees hold and deal with the assets of the trust for the benefit of the beneficiaries. In order to ensure that this happens properly, most trusts will have a set of rules contained within its “trust deed”. All parties of the trust are bound by these rules.

For example, in the case of a “wealthy family trust fund”, the trust deed would state that the children cannot become a trustee of (or possibly even able to withdraw money from) the trust until they are 21 years old.

The parties of a trust are therefore bound by two sets of rules – the trust deed and the law. The trust deed cannot permit a person to do something the law prohibits, and the reverse is often (but not always) true also.

Because of the possible ramifications of breaking the trust rules, all parties need to ensure that they fully read and understand the trust deed before signing it.

It should be noted that there does not need to be a trust deed for a trust to exist, but the absence of one will result in the law dictating the terms of the trust.

Trust Minutes

A trust must keep records of the decisions that it (or rather the Trustees) make. These records are called "minutes".

If you think about it, there are many decisions made by a trust during a year - what expenses to pay, what assets to buy, changes is business directions, etc.

Thankfully, a minute doesn't have to be created at the same time a decision is made - or else you would hundreds of minutes floating around - you can create a minute at a later date confirming that the decisions and actions made were in accordance with the wishes of the Trustees.

There is one particular decision that Trustees make that is very important as it can have significant tax consequences - the end of year distribution.

Year end distribution and its subsequent minute

By Law, the Trustees must decide how to distribute the income of the Trust by June 30 (i.e. the last day of the financial year). Should the Trustees fail to make this decision; the Trust will pay 46.5% tax on the income.

This poses a few problems, the main one being - how does the Trust decide how much to distribute to each beneficiary if it doesn't know (accurately) how much profit it has made? As the accounts of the Trust are always done after 30 June, it is a dilemma.

This can be overcome by the Trustees making the decision to distribute according to a formula - for example, a specific percentage of income.

Then, when the actual dollar amount has been determined, a minute can be created stating what the formula was, and the dollar amount resulting from that formula.

This two step process is very important as the ATO have indicated that it will be taking a very hard stance on Trustees that haven't made the decision to distribute by June 30.

Types of trusts

As you could imagine, there are a large number of purposes for setting up a trust. Separation of control from ownership, business ventures, asset protection, and (importantly) tax minimisation just to name a few.

As such, most trusts can be organised into groups depending on how their main rules operate. While there are many groups, the main ones are:

- Discretionary trust;
- Fixed trust;
- Superannuation fund;
- Hybrid trust;
- Testamentary trust.

Discretionary trust

This is by far the most common trust. A discretionary trust is often used by a small business owner wishing to minimise his or her tax.

This type of trust gives the trustee complete discretion as to which beneficiaries receive capital or profit distributions in a particular year.

For example, Mr. A and Mrs. B operate the AB Trust and run their business from it.

In year 1, the AB Trust makes a profit of $50,000 and the trustees distribute these profits 50:50 to Mr. A and Mrs. B.

In year 2, Mrs. B gets a high paying job as a solicitor while Mr. A concentrates on the business. The AB Trust makes a $70,000 profit. As Mrs. B already has a high income, it is beneficial for tax purposes that the trustees distribute all $70,000 to Mr. A.

Fixed trust

Also called a unit trust. Very useful when you want the distributions to be non-discretionary.

The trust deed can stipulate which beneficiaries are entitled to what portion of income and capital, or more commonly, entities can purchase units in the trust (similar to purchasing shares in a company) which entitle them to a portion of the trust.

A fixed trust is popular when non-related parties are running a trust, as each individual is guaranteed his or her share of the property and its income.

For example, two business partners (Mr. X and Mr. Y) decide to purchase a property via the XY Fixed Trust. In order to ensure that each person benefits equally, they each purchase 1 unit in the trust and are therefore entitled to half of the income and capital of the trust each.

An expansion of this setup would be for Mr. X and Mr. Y to each set up a discretionary trust, and those discretionary trusts hold the units in the fixed trust.

Following on from the above example, Mr. X sets up the X Discretionary Trust, and Mr. Y the Y Discretionary Trust, and use those two trusts to purchase the units in the XY Fixed Trust.

In year 1 the property returned a $40,000 profit and distributes it according to the unit holdings. The X Discretionary trust therefore receives $20,000 and can distribute it to any of its beneficiaries as it sees fit – as can the Y Discretionary Trust. This allows Mr. X and Mr. Y to distribute the profits from their property to other members of their families, which may be beneficial for tax purposes.

Superannuation fund

A superannuation fund is a special type of trust. It operates very differently to other trusts in many aspects, the main difference being the taxation of the superannuation fund.

As discussed further below, a trust is generally not taxed on its income, rather the beneficiaries are taxed on their share of the income. A superannuation fund is different as it is prevented from distributing its profits to its beneficiaries, and therefore the superannuation fund must be taxed on the taxable income.

In order for the superannuation fund to get the 15% tax rate, it must meet the conditions set by law. In order to meet these conditions, the trust deed (or super fund deed) must be drawn up correctly to meet these laws. A fund not complying with the law is taxed at 46.5%.

A superannuation fund is neither a discretionary trust nor fixed trust. Only certain individuals can be beneficiaries (known as members), and each member **must** be a trustee in the case of a superannuation fund.

Hybrid trust

A hybrid trust is normally a combination of a discretionary trust and fixed trust – being that some distributions may be fixed, and others discretionary.

A common type of hybrid trust is where all income distributions are discretionary, but capital distributions are fixed. (A capital distribution refers to the proceeds of an asset's sale, or the distribution of the physical asset.)

For example, Mr. P sets up the P Hybrid Trust and purchases a property in it. He intends on the property being passed to his only child when he turns 21, who is only 11 now.

Under tax law, profit distributions to his child while under 18 are adversely taxed, so a fixed trust with the child as the unit holder is not suitable. A hybrid trust allows Mr. P (as the trustee) to distribute the income to himself (or another relative), while preserving the asset for the benefit of his child.

Testamentary trust

This trust is often automatically created upon the death of an individual. The deceased's assets pass to the executors in trust for the beneficiaries of the deceased's will (*i.e. the executors are the trustees, and the deceased's spouse, children, etc are the beneficiaries*).

The testamentary trust does not have a trust deed, being governed entirely by laws.

Taxation of a trust

There are two possible taxation options for a trust. Firstly it can fail to distribute its income to beneficiaries (discussed earlier) and pay tax at 46.5%, or it can distribute all of its income to one or more beneficiaries and those beneficiaries pay tax at their tax rate (the preferred approach in 99.99% of cases).

Where the trust distributes, the amount of tax payable will depend on:

- The type of entity receiving the distribution;
- The type of distribution being received (ordinary income, capital gains, etc); and
- What other income that entity has.

Type of distribution being received

A trust can distribute either or both its income and capital to its beneficiaries.

Capital distributions

When a capital item is distributed (either a physical asset is passed to a beneficiary, or the sale proceeds of an asset are), generally only the capital gain is taxable to the beneficiary.

For example, the AB Trust sells a block of land for $200,000 which cost $150,000. Mr. A (the beneficiary) is taxable on $50,000, even though he received $200,000.

Due to the complexities in Capital Gains Law, it is possible for the above to be untrue under certain circumstances. Do not rely on the above simplistic example if you are selling an asset in a trust, always consult a tax advisor first.

The tax on a capital gain can be reduced in a number of circumstances. The most common is the CGT Discount available to individuals and superannuation funds. Assets held for more than 12 months may be eligible to an exemption of 50% for individuals, or 33.3% for superannuation funds.

This means that where this capital gain is distributed to an individual or superannuation fund, they will pay less tax when compared to it being distributed to a company.

Following on from the earlier example, if the AB Trust held the block of land for more than 12 months, Mr. A may be able to exempt 50% of the gain, making only $25,000 taxable. If the distribution was made to a company, that company would pay tax on the full $50,000.

Income distributions

Generally, all income distributions are taxable – whether they are business profits, foreign income distributions, dividends, etc. The "character" of the income flows with the distribution which can be important in some circumstances.

Following the example again, part of the AB Trust's income was rent earned from a property held in the New Zealand (called foreign income). Mr. A and Mrs. B are both Australian residents, so if they receive this income they will pay tax on it, however Mr. A has a relative that is not a resident who can benefit from the trust, and under our Tax Law wouldn't pay tax on this amount.

Type of entity receiving the distribution

Companies are taxed on 30% of all income, regardless of the amount.

If another trust receives a distribution, it does not pay tax, but passes it onto its beneficiaries. It is possible for income to pass through an unlimited number of trusts before being an entity capable of being taxed has to pay the tax on the distribution.

If an individual receives a distribution, that income is added to his or her other income and taxed at their marginal tax rate.

Other income the entity has

If an individual has no other taxable income, then the first $18,200 is tax free, the next $18,800 taxed at 19% and so on (based on 2017 tax rates).

If an individual already has $200,000 of taxable income from other sources (wages, dividends, etc), then the distribution will be taxed at the top marginal tax rate (currently being 47%).

For example. The AB Trust makes a $50,000 profit and distributes $20,000 to Mr. A, and $30,000 to their related company (AB Company Pty Ltd).

AB Company Pty Ltd will pay $9,000 tax on its income as companies are taxed at 30% on all income. Mr. A will have his distribution added to his other income to determine his tax liability.

If Mr. A has no other taxable income, then he will pay $2,100 tax on his $20,000 distribution. If Mr. A has $200,000 of other taxable income, he will pay $9,300 of tax on his distribution.

Most other entities have a flat tax rate on all income, but there are odd occasions where this is varied. It is always a good idea to check with your tax advisor on your specific circumstances.

Accounting for Trusts

We find that there are two common barriers to people understanding how their trust operates:

- Taxable vs Physical distributions; and
- Wages vs Drawings.

Taxable vs Physical distributions

When a trust makes a profit, it ***must*** distribute that profit to its beneficiaries – the problem arises that in most businesses, the cash isn't available to physically distribute those profits.

For example. Mr. G runs his business through the G Discretionary Trust. In starting the business, the G Discretionary Trust borrowed $100,000 for plant & equipment, payable within 2 years. In its first year, the business made a $50,000 profit, but as it had loan repayments to make, has no cash available (see below balance sheet).

Assets		Liabilities & Equity	
Plant & equipment	$ 100,000	Bank Loan	$ 50,000
		Profits	$ 50,000

In the above example, the cash flow from the profits (loan repayments are not expenses and do not reduce profit) have been used against existing liabilities.

Many people have trouble understanding how they can be taxed on a distribution that they do not physically receive.

The answer is that those profits are treated as being distributed, but then loaned back into the trust. This is money that the beneficiary that paid tax on the distribution can claim from the trust when it does have cash, and pay no tax on the withdrawal as it is merely receiving a loan repayment.

Following the above example, the balance sheet of the G Discretionary Trust after accounting for the non-cash distribution would look like this:

Assets		Liabilities & Equity	
Plant & equipment	$ 100,000	Bank Loan	$ 50,000
		Loan from Beneficiaries	$ 50,000

Wages vs Drawings

In many small businesses, it is simply a one man or one woman show. For tax or asset protection reasons they don't operate as a sole trader, but rather a trust or company.

As the trust is running the business, it can pay a wage to any person working in the business – which includes the one man or one woman running the show.

For example, Mrs. Q sets up the Q Discretionary Trust and runs her solicitors practice from it. The Q Discretionary Trust can pay wages to anyone working in the business – including Mrs. Q.

These wages are deductible to the trust, and taxable to the individual (just like any other business).

What confuses many people, is that they believe that all money they take from the trust is wages, when in fact it isn't. These amounts over and above any wage are allocated to a loan account in the trust financials.

Following on from the above example, Mrs. Q decides to pay herself a wage of $104,000 per year, so she sets up a direct debit for $2,000 (less tax) per week. One night her house is burgled and she is uninsured – and she takes $30,000 from the trust bank account to re-buy all her furniture etc.

This withdrawal is not a wage, but a loan from the trust to herself. This loan does not form part of her wages, and is therefore not taxable.

Now, if you're thinking that I'll just take all my money as a loan from the trust and never pay tax – ***STOP***. It's not quite that easy.

Remember, wages are deducible to the trust, but loan made or loan repayments are not. Generally, for a business to make cash, it must make a profit. The less wages taken, the higher the profit in the trust which has to be distributed.

Example: Mr. W sets up the W Discretionary Trust and runs his accounting practice from it. He employs no other staff. In year one he earns $154,000 in fees, pays $50,000 in expenses, and has taken $104,000 out of the trust for personal use (i.e. personal bills, mortgage repayments, etc)

There are two possible options here – wages or drawings (loan). Both will result in someone paying tax on $104,000.

Option 1 – Wages: During the year, Mr. W withdrew $2,000 (less tax) per week as a wage. The W Discretionary Trust has remitted the tax on the wage to the ATO, and can therefore include $104,000 of wages in its expenses. The W Discretionary Trust therefore makes a profit of $0.

Option 2 – Drawings: Mr. W allocates the $104,000 to his loan account. As this is not an expense, the W Discretionary Trust makes a $104,000 profit, and must distribute this to its beneficiaries. For tax reasons, the trustees distribute $30,000 to Mr. W, $70,000 to Mrs. W, and $4,000 to their children. The accounts of the trust will show that Mr. W owes the trust $74,000 ($104,000 taken less $30,000 allocated to him), while the trust owes Mrs. W $70,000 and the children $4,000 (their distribution amounts).

As you can see, by taking less wages, Mr. W has allowed the trust to distribute the taxable income to other people (who may be on better tax rates), thereby saving some tax.

Warning: While Option 2 above may be the best approach for tax reasons, there are other factors that must be considered when choosing between wages and drawings. Don't rely on the simplistic example above as it does not take into account any of these other factors, one of which being that those other beneficiaries have a legal right to that money that was "distributed" to them.

Distributions to Companies

As mentioned above, when a trust makes a profit, it must distribute that profit to another entity (so that entity can pay the tax on the profit) regardless of whether there is cash available or not.

This distribution often creates a "loan" (technically it's an unpaid present entitlement, but we won't split hairs here) where an amount of money is owed to the entity receiving the distribution.

When this "loan" is to a company, it can cause problems due to Division 7A of the Tax Act which basically tries to make this loan taxable (essentially creating a situation of double taxation).

In the past it hasn't been a major issue (as there were ways around it), but the laws have been tightened and it is now a problem in pretty much all instances.

Division 7A Basics

A simple explanation of Division 7A is that the Government is trying to prevent companies from loaning money to shareholders, or giving rise to any transaction that essentially creates the same scenario.

This is designed to prevent companies with shareholders on high incomes deliberately not paying dividends (so as not to have the shareholders pay tax on that money at the top tax rate), but instead loaning that money to the shareholders with no real expectation of repayment or interest.

Essentially the "loan" is a sham and a tax-avoidance scheme. To counter it, the decision of the Government was to make that loan amount taxable in the hands of the shareholder, with no deduction allowable to the company (hence the effective double taxation).

Bucket Companies

A "bucket company" is basically a company that does nothing except receive trust distributions – it acts as a bucket for any trust distributions the individuals don't want (or don't want to pay tax on).

A bucket company has been previously used in situations where the individuals are on high personal incomes and they want to save some tax by using the company 30% tax rate, but want to use the money themselves.

For example, the GY Discretionary Trust makes a profit of $200,000. Mr. G and Mrs. Y each have personal incomes of $250,000 and therefore any trust distributions will be taxed at the top tax rate of 46.5%.

Mr. G and Mrs. Y have a company that does nothing and they distribute the $200,000 to their bucket company BC Pty Ltd. They choose not to pay the $200,000 to BC Pty Ltd, but the trust instead loans the money to Mr. G and Mrs. Y.

Essentially, Mr. G and Mrs. Y have gotten use of the $200,000, and avoided the extra tax by having the company pay only 30% tax instead of their personal 46.5% rate.

Why is this situation caught?

While the company hasn't directly made a loan to its shareholders, it has performed actions that essentially created the same situation (i.e. money that is legally the company's is being used by the individuals).

The bucket company has a legal right to the $200,000 distributed to it, and by choosing not to enforce that payment (and therefore allowing the trust to loan the money to the individuals), the company has essentially loaned the money to the individuals itself.

What to do going Forward

There are really only a few options for trusts that distribute to companies:

1) Physically pay the distributions to the company (which is understandably hard where the trust has no cash); or

2) Avoid distributing to a company.

Unfortunately there are no other real options (that are simple anyway). If you are running a trust and for some reason feel as if you ***must*** have unpaid distributions to a company, you should see your tax advisor.