Trusts

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CONTENTS

Trusts	1
Family succession planning	15
Creative strategies	16
Additional information and reading on trusts	17

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Definitions

Many different types of trust exist at law.

To illustrate, superannuation finds normally involve trust arrangements, as do many charities. Solicitors, stockbrokers and other professionals use trust accounts in respect of client's money. Other uses of the concept commonly encountered include cash management trusts and unit trusts generally.

There are also "statutory trusts", created by the operation of law — for example, in relation to persons unable to look after their own affairs.

There are even "bare trusts" — trusts where the sole obligation of the trustee is to convey property to beneficiaries when required to do so.

A trust is simply a legal obligation to hold properly for the benefit of others.

An inter vivos family trust, can be thought of as a similar arrangement to that provided by a will, except that it 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 instead of by deed. Such a trust is known as a testamentary trust.

Either way, the beneficiaries of such a trust would in the main be members of the family of the person instigating the arrangement. The term "family trust" is a purely descriptive one; it is not a legal term.

Deed of Trust

A trust is established with the payment of an amount, called the Settled Sum, to the Trustee to be held in accordance with the Deed of Settlement for the benefit of the Beneficiaries. The Trustee is to hold all trust property, the Trust Fund, and invest such assets for the Beneficiaries.

The Appointor may remove/replace the Trustee in accordance with the Deed of Settlement.

The Deed of Settlement provides for a Vesting Day on which the Trust is to terminate. On the Vesting Day, the Beneficiaries are entitled to the whole of the Trust Fund. Until that day, distributions of income or capital are made at the discretion of the Trustee, in accordance with the Deed of Settlement.

Settlor

A trust inter vivos may be created either by a declaration of trust in respect of property specified in the declaration, or by the settlement of money or other property by a person upon a Trustee upon trust, to deal with it as provided in the Deed of Settlement. The Settlor may not be a Beneficiary of the trust without there being serious taxation consequences. A liability to stamp duty arises when a trust is constituted and therefore, consideration should be given to the amount of the Settled Sum and any gifts or transfers of property to the trust.

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Trustee

A Trustee of an express private trust inter vivos may be appointed by the Appointor; pursuant to an express power contained in the trust instrument; in certain cases by the courts; and under the provisions of the various Trustee Acts of the States and Territories.

The duties of a Trustee are many, and they may be held personally liable for debts incurred in their capacity as a Trustee. The Trustee has the right of indemnity out of trust assets, but it may occur that trust assets are less than liabilities.

If the trust is a trading trust, then it is advisable that the Trustee be a company. Resolutions should be signed and maintained when the Trustee makes a decision or takes an action.

The Trustee is to maintain proper accounting records, including books of accounts, which show all receipts, payments and distributions of income. A Profit and Loss Statement and a Balance Sheet should be prepared, and relevant returns and statements lodged with the Australian Tax Office if income is derived by the Trust.

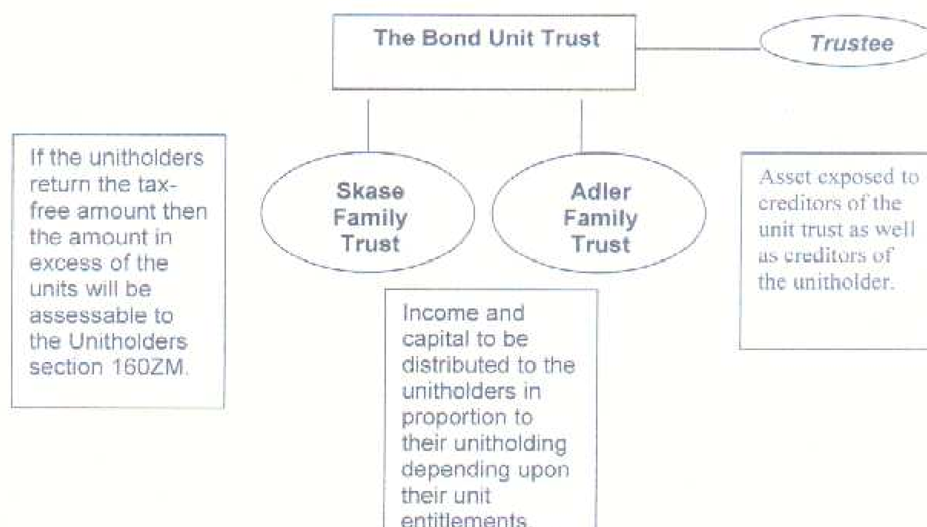
Investing with partners

In the past, companies and unit trusts have been favoured because, unlike a partnership of individuals, they offer each party a fixed interesting the structure as well as asset protection.

Companies have tended to lose popularity in recent times due to the costly and complex rules administered by ASIC and a number of tax disadvantages and disincentives.

e.g No CGT discount, strict carry forward loss laws, difficult to pass on company tax concessions to shareholders, Division 7A etc.

Therefore, one option may be a unit trust whose units are owned by discretionary trusts.



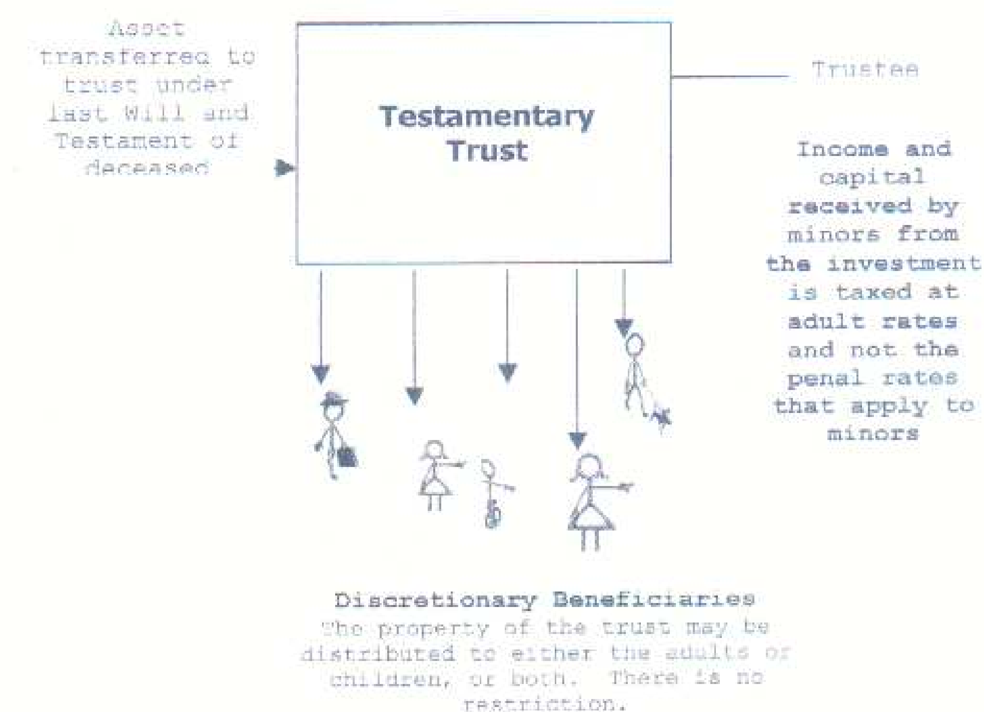
family succession planning

Deceased Estates

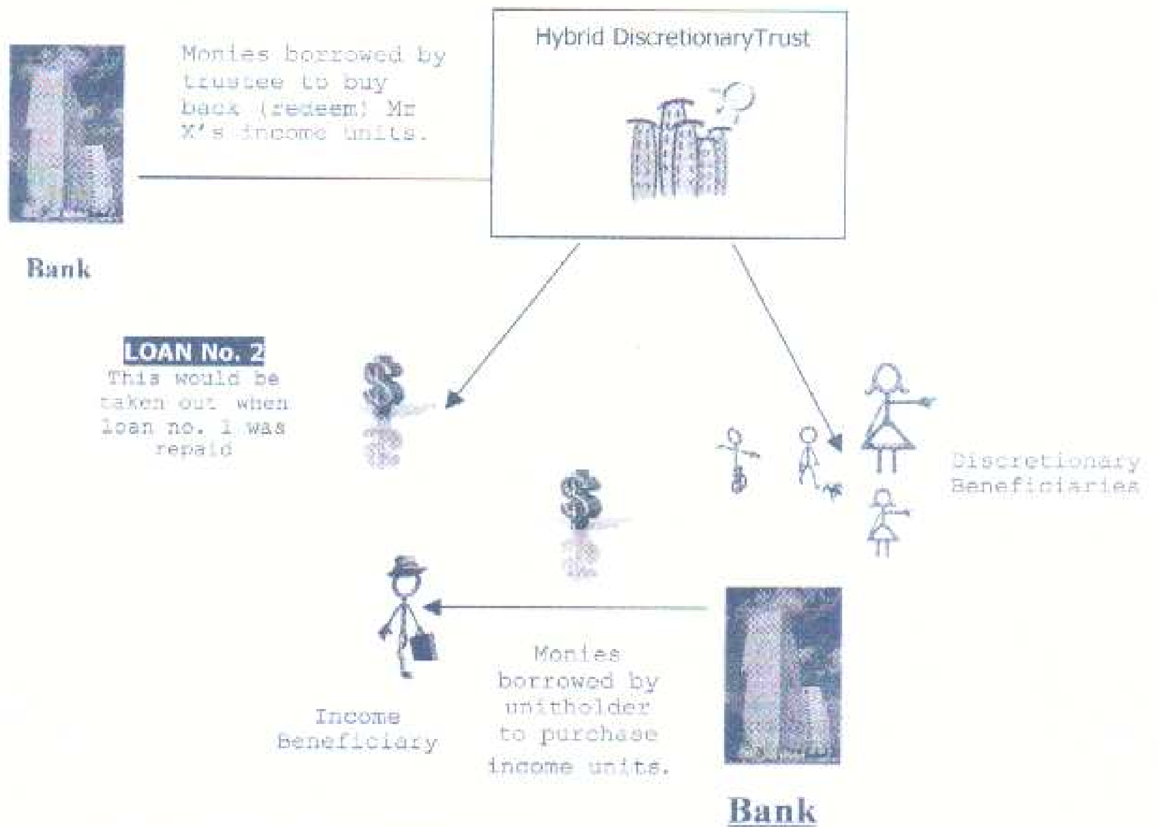
The tax relief that is available to the beneficiaries of deceased estate provides a wide range of tax planning opportunities.

Testamentary Trusts

The main benefit of a testamentary trust is that certain amounts of its assessable income distributed to minors is excepted trust income which is not subject to penal tax rates.



The Refinancing Principle



types of trust

Many different types of trust exist at law.

To illustrate, superannuation finds normally involve trust arrangements, as do many charities. Solicitors, stockbrokers and other professionals use trust accounts in respect of client's money. Other uses of the concept 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 the operation of law — for example, in relation to persons unable to look after their own affairs.

There are even "bare trusts" — 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.

An inter vivos family trust, can be thought of as a similar arrangement to that provided by a will, except that it 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 instead of by deed. Such a trust is known as a testamentary trust.

Either way, the beneficiaries of such a trust would in the main be members of the family of the person instigating the arrangement. The term "family trust" is a purely descriptive one; it is not a legal term.

Documentation for a 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 even an "indenture".

Beneficiaries can be named individually, but more commonly in a modern deed they are named as a broad category — for example, "all the children of Peter Pan".

Such a deed is subject to stamp duty imposed at the State Government level.

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

A trust created by deed is sometimes referred to as an "express trust" or a "declared trust, in distinction form a "constructive trust" or an "implied trust", which is established by conduct — for example, by opening a bank account with words such as ". . . as trustee for in the name of the account.

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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, except where there is some particular reason for doing so. Furthermore, in some cases naming a person as a beneficiary in a trust deed may raise false expectations.

Beneficiaries do not have to be natural persons — thus, for example, family companies, other family trusts and, if desired, unconnected charities, non-profit organisations (preferably ones which have been incorporated), and so on, can also be included. It is usually desirable to also name some entity as the residual or default beneficiary in order to cover the possibility that none of the other potential beneficiaries is alive at some future time.

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 which had previously been set up orally. A trust deed would normally name the initial trustee or trustees and set out the mechanism for filling casual vacancies and, if desired, for making additional appointments.

It should be noted that a trust is not a legal entity. (However, the Goods and Services Tax Legislation 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. At present this principle extends to the taxation of trusts.

The parties to a Trust

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

The "senior" (occasionally called the "grantor"). This is the individual who 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". The duties of this person are to administer the trust in accordance with the deed and the law and (very often) to exercise various discretionary powers. The duties and powers of a trustee are discussed in greater detail below.

The "beneficiaries". These are the persons who collectively 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 "appointer". Such a person can be given a power to remove or appoint trustees, and a power to nominate a successor as appointer.

Alternatively, in the ease of some trusts, a "guardian" or "protector".

A guardian can, for example, be given:

a power of veto over certain types of transaction
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

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a power to nominate a successor as guardian or protector.

types of trust

The trustee owes a fiduciary duty to both the settler and the beneficiaries.

The trustee also acts as the legal owner of the assets constituting the trust find. Thus bonds, shares, land and motor vehicles, for example, 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 really “belong” to the trustee in the ordinary sense of that 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” and the whole arrangement can be described as an “inter vivos trust” — or, by those who prefer English expressions to Latin ones — simply as a “living trust”.

In the ease of both wills and trusts varying percentages can be allotted to different beneficiaries, although naturally these percentages should add up to 100 per cent. Furthermore, assets and income can be distributed separately, so that, for example, all the income could go to a wife for life and the capital (the corpus) could go to the children of the family in equal shares on her death.

In strict theory, the settler of a trust could also be one of the beneficiaries of that trust. However, such a combination would probably lack credibility and if it were to be used then the genuine nature of the entire trust arrangement could be open to challenge. It is thus preferable to name as the settler of a family trust a person who is not related to the relevant family and who is not otherwise involved with it.

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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 settler not to be a trustee. The beneficiaries can also, if desired, include the trustee. However, the legal ownership of the property, which the trustee holds in order to carry out the trust, always remains separate from any interest, which 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 person becoming beneficiaries (for instance, by being born or attaining a certain age).

A person who declares that some particular property owned by him is to be held by him in trust for someone else becomes both a settler and a trustee.

Other preliminary points

In Australia trust law and a number of important taxes affecting trusts — notably stamp duties and land tax — are in the province of the 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.

Trust law is to a large extent not found in statutes. Rather it is now part of the "common law" — the past decisions of the superior courts and the precedents, which 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.

Most modern family trusts are discretionary trusts. This means that the precise persons who are to receive benefits from the trust each year and the amount that each is to get 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 come from the categories defined in the deed and likewise the totally 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. It must have adequate funds under management and these have to be invested wisely.

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.

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Object of a Trust

Firstly outright gifts do not need trust arrangements.

Those setting up a family trust usually have a range of overlapping objectives in mind, such as:

- to make provision for the family, including in particular very young children
- to attach certain conditions to gifts
- to give children the benefits of family wealth without losing control over key assets
- to create a legal framework for the family assets which will last for a long time
- to protect these assets against actual and potential creditors
- to pass wealth from generation to generation
- to create a tax effective structure
- to safeguard certain social security entitlements
- to create a single relatively large pool of investments funds which has more scope to perform well and to develop a long-term strategy than a series of smaller pools
- to allow administrative, investment and record-keeping functions and possibly also property management functions to be centralised and handled more efficiently and at a lower cost
- to act as a de facto superannuation vehicle, without the restrictions applying to conventional superannuation
- to escape death and gift duties should these ever be reintroduced into Australia
- to vest discretionary powers in someone who can assist the above tasks.

A properly set up family trust can also help a family to cope better financially with a crisis such as business failures, deaths and disability. A family trust structure can, for example, assist with the ongoing costs of raising and educating children in such circumstances. Other uses for a family trust are also possible — for example, a father who has remarried could, if desired, use a family trust as a route for satisfying his moral obligations to provide financially for any children from a prior marriage who are no longer living with him.

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If assets have been transferred to a family trust by a person who subsequently becomes incompetent to handle his or her affairs then the management of those assets can continue as before within the trust structure — without the intervention of a court-appointed official, as could happen in respect of personally owned assets in those circumstances.

Privacy

A trust can assist a family to maintain its privacy. The existence of a family company cannot be kept secret because of the Corporations Law requirements. Details of a company's directors and shareholders are always in the public domain.

Again, a copy of a proven will is a public document.

In contrast, the existence of a family trust and details of the trust deed and the trust assets can be kept very quiet. There is no inspectable register of trusts and there is no obligation on anyone to file any returns, which are open to public scrutiny. If desired, trust assets can even be registered in the name of some nominee company as an additional privacy measure.

Quite apart from the understandable desire of most people to keep their affairs to themselves (and out of sight of nosey neighbours, reporters, business competitors and the like) the maintenance of privacy in regard to one's wealth has a more serious purpose. Secrecy can reduce the chance of being burgled or becoming involved in kidnapping demands.

Discretionary powers

The discretionary power can typically be conferred where it is desired to empower the trustee to decide which beneficiaries should receive income in any year and also when and to whom any capital distributions should be made.

A trustee can then have regard to factors such as the following:

- the ages of the potential beneficiaries
- the educational needs of children
- the housing needs of the families concerned
- the need for working capital or seed money by any beneficiary
- medical problems
- the other income already flowing to each of the potential beneficiaries
- the assets and liabilities of each of the potential beneficiaries
- marriages, divorces, births and deaths
- retirements, redundancy and the like
- actual or potential bankruptcies
- the setting up or closing down of business
- income tax considerations
- social security rules
- individual weaknesses — for example, an addiction to gambling.

The above is not meant to be an exhaustive list.

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To illustrate, one possible way of dealing with the capital and income aspects in order to satisfy conflicting objectives might be to use an approach occasionally used in wills. This is to arrange for the income of the trust fund to flow substantially to the mother in a family but only as long as she is alive, with the capital later on being distributed to the children on her death.

Assets held in a trust — not being the personal assets of the trustee or any beneficiary — are protected in the event of matrimonial disputes. Trust property is not property of a marriage and is therefore not divisible between the partners of that union. However, the Family Court of Australia which has jurisdiction in such matters could, no doubt, if it wished take the existence of a family trust and the likely benefits flowing from the trust into account when apportioning the normal assets of the marriage. Such an approach is often used in connection with superannuation.

Bankruptcy

A particularly useful feature of the law is that assets which are being held in a trust fund for the benefit of a particular person — as distinct from assets already actually distributed to and thus owned by that person — are automatically protected from seizure by that person's creditors. This can be very important in the event that, for example, some business venture goes wrong or the person concerned unexpectedly becomes liable for damages of some kind.

Furthermore, where a potential beneficiary has already become bankrupt, a discretionary trustee can ensure that the timing of distributions to that person can have regard to the expiry date of the bankruptcy period. Unless this is done distributions to the beneficiary will flow to the beneficiary's creditors instead of being available to the beneficiary as intended.

Divorce

Assets which are being held in a trust fund for the benefit of a particular person can also have advantages in divorce situations.

For example, a house owned by a person outright might have to be sold, with some of the proceeds passing to an ex-spouse as part of a divorce settlement. A house owned by a trustee could be retained and leased to the beneficiary for a peppercorn rent.

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Disability before death

The way in which a family's assets are owned deserves some serious study. If, for example, all such assets are registered in the name of the father of a family who is the only breadwinner and who has a wife and young children, then a number of disadvantages arise.

One of these is a function of the income tax laws — such a structure will usually mean far more tax is being paid than is really necessary.

However, quite separate from that are the practical problems which can arise in the event of the father in such a scenario ever becoming incapacitated, possibly unexpectedly and/or many years before he actually dies. Many difficulties can then be encountered in dealing with any assets which are registered in his name, even if the disability turns out to have been a temporary one only.

On the one hand, the family may have great difficulty in coping with the problems of ordinary day to day living if the assets and the income which was intended for their benefit cannot, for legal reasons relating to the title of those assets, be touched by them.

Presumably it would not have been the father's wish that during a "limbo" period in which he is unable to act for himself his family should be worse off than they were previously — or, for that matter, than they would be after his death (when an executor with full power to act would be in control of his deceased estate).

On the other hand, the total value of the assets themselves may erode if no one has the authority to make the normal management or investment decisions appropriate to the circumstances — especially determinations needing to be made on an ongoing basis.

One solution to this dilemma is to hold the assets through a family trust, so that these mechanical issues can be handled by a suitable trustee.

Capital Gains

For some purposes the nett increase in unrealised capital gains over a financial year is treated as income. This is logical, because it represents an increase in wealth in the same way as the actual receipt of interest, dividends or rent. However in trust accounting practices unrealised capital gains would usually be ignored

Realised capital gains would normally be recognised, but trust deeds may treat them in one of two very different ways.

Under one approach, they would be treated as income and distributed to the income beneficiaries. Any associate capital gains tax liability would naturally flow to such beneficiaries.

Under the other approach, realised capital gains would be treated as being for the trust's capital account and would eventually flow to the capital beneficiaries - a treatment which is consistent with that used for assets which are not disposed of. In that case any associated capital gains tax liabilities would have to be picked up by the trustee as "representing income to which no beneficiary is presently entitled" and debited to the capital account.

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Deductions

The rules governing tax deductions for trusts are substantially the same as those for individuals, although obviously concepts such as having a spouse or residing in a particular zone of Australia have no application to an inanimate trust.

"Allowable deductions" fall into two main classes:

- Those incurred in earning assessable income which are deductible under section 51 of the income tax assessment act 1936;
- The so-called "concessional deductions", such as donations to charities.

In context of a family trust which is a portfolio investor expenditure items such as the following are tax deductible:

- Fees for professional advice
- The cost of financial journals
- Computer software
- Financial institutions duty (FID) and debits tax
- Bank charges
- Postage and telephones

Also deductible is any interest on money borrowed for the purpose of buying shares or property (or making other income producing investments).

Apart from interest, any further expenses in relation to such loans arc covered by section 67 of Income Tax Assessment Act 1936 and are deductible in stages.

Typically, such expenses would include some or all of the following:

- Establishment fees.
- Procuration fees.
-

There may be additional legal costs if disputes ever arise.

Potential lenders may impose extra charges to cover the expenses involved in vetting trust deeds and the like.
There will also be further costs when the trust is eventually wound up.

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If a company structure is to be used then there will be additional costs for setting up or acquiring the company, for maintaining statutory records and for various filing fees.

Most of the above costs do not vary with size.

The total costs of setting up a trust will usually be considerably greater than the cost of making a simple will. However, any meaningful comparison would need to take the subsequent costs at the probable and distribution stages into account also.

Furthermore, the existence of a family trust does not, of course, eliminate the need for a will and thus also the usual costs associated with that. In addition to all the above there will naturally also be expenses of the type incurred in respect of any investment portfolio whether owned by a trust or otherwise.

These would normally come out of the trust fund and thus affect its overall rate of return.

One way to save money should be mentioned. There would probably be cost savings — as well as other significant advantages, if all related legal documentation were to be dealt with at the one time - for example:

- the trust deed
- the associated asset transfers
- any concurrent agreements
- the wills of the persons involved
- powers of attorney
- any appropriate changes relating to family companies.

The latter could involve shareholders, boards of directors, dividend declarations and/or the constitution of the company (previously referred to as its “articles of association”).

Changed circumstances

Once money or other assets have been given to a trust a permanent alienation has occurred.

The donor has no right to seek the return of any assets, even if circumstances have changed drastically and unexpectedly — for example:

- the impoverishment or bankruptcy of the donor
- the death of all the intended beneficiaries
- matrimonial or other disputes leading to estrangements.

Of course, the donor may have certain rights over the assets in capacities, other than as a donor — in particular, rights as a beneficiary.

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Loss of flexibility

Using a trust structure inevitably involves some loss of flexibility.

Individuals can deal with their own assets as they see fit. In contrast, trust assets must be dealt with strictly in accordance with the terms of the specific trust deed and the law relating to trusts. This may be inconvenient if some unforeseen event should make those provisions seem too restrictive.

Setting up a trust is relatively easy; winding it up — while clearly not impossible — may nevertheless be much more difficult and in any case winding the trust up may not overcome the problem.

It must also be borne in mind that, generally speaking, transactions cannot be reversed even if with the benefit of hindsight those concerned may wish that they had not been entered into in the first place. Of course, similar problems can arise in the case of deceased estates. A mechanical nuisance can be that for certain transactions trustees may be required to prove their authority to act.

The role of the Trustee

The important role, which the trustee plays in a family trust was explained earlier.

The word “trustee” is often used loosely to cover one of a number of possibilities, typically:

- An individual (called a “sole trustee”).
- A group of two or more persons required to act collectively sometimes known as a “board of trustees”).
- A corporation.
- Any person who is not a minor and who is not of unsound mind can be appointed as a trustee.

Corporate Trustees

Using a company as trustee has both advantages and disadvantages.

The corporate trustee could be a small family-controlled company either formed specifically for that purpose or already in existence for other reasons. Such a vehicle would probably act without payment. Normally proprietary limited companies are used, but a company limited by guarantee would also be suitable.

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Alternatively, the corporation could be (say) a private sector statutory trustee company or a State Government instrumentality charging fees on a commercial (and authorised to do so by the terms of the trust deed).

Under a change to the corporations legislation effective from 5 December 1995 small private companies can, if desired, act with only a single director. In that case the decision making processes would be very similar to those applying to trusts with a sole personal trustee.

Furthermore, a private company can now exist with only one shareholder and such an entity is no longer required to hold annual general meetings or file detailed financial statements. Thus running such a company has become much simpler.

These features are also relevant when considering the use of a company structure in a completely different way — as an alternative to a family trust.

The advantages of using a company as trustee are:

> It can stay in existence virtually for ever — unlike human beings it does not die or ever become senile. (This is a slight overstatement: companies can be wound up, either voluntarily if desired or on occasions compulsorily). This avoids the need to have certain assets re-registered in a new name on a change of personnel such as that resulting froth the death or retirement of an individual trustee. It also avoids the costs and inconvenience of having to deal with the executor or administrator of the estate of a deceased trustee.
>
> The person in de facto charge of the company can effectively control the affairs of the trust without actually being a trustee.
>
> Using a company reduces risk by virtue of its limited liability.
>
> It avoids the possibility of being bound by certain orders of the Family Court of Australia which could apply to individual trustees.

It may enable insurance against accidental breaches of trust to be obtained. On the other hand, the disadvantages of using a company are:

> There are the expenses of setting it up (or acquiring it) in the first place, of running it on an ongoing basis, and possibly also of eventually winding it up.
>
> There is a need to keep various company records and to lodge various statutory forms (annual returns, changes of address, changes in the persons holding office, and soon).
>
> Suitable persons to act as directors may be hard to find (although one person is sufficient under the Corporations Law).

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If the directors are husband and wife, then practical difficulties can arise if the marriage breaks down.

Paperwork is involved in transferring shares to a new registered owner on the death of a shareholder.

Of course, while using a company as trustee has some advantages in relation to the paperwork and relations with the outside world, the practical problem of finding suitable persons for the real underlying task is identical whether these persons are made directors of a trustee company or are just invited to act as individual trustees.

If a family company is used it could:

- Be the trustee of just the one fund.
- Be the trustee of more than one fund.
- Be a fund trustee and conduct other business in its own right as well.
- Act as the trustee of an associated superannuation fund.

A company does not necessarily have to be wound up when a trust of which it is trustee is terminated, even if that was up till then its sole activity.

Dual roles

The fact that a company is the trustee of a particular family trust does not prevent it from also being a beneficiary under the same trust if that is desired.

Nominee companies

A half-way house also exists. Individuals can act as the actual trustees but the assets can be registered (if the deed so provides) in the name of a suitable nominee company with no decision making powers.

Statutory trustee companies

The possibility of using one of the relatively small number of statutory trustee companies operating in Australia as the trustee of a family trust (or, for that matter, as the executor of a deceased estate) was mentioned above.

These are usually old-established, conservative institutions with large staffs and large funds under management. They advertise themselves as being very experienced in trustee work and as being able to provide an ongoing service without the problems of individual trustees dying or just being unavailable.

However, notwithstanding their credentials overall, in recent years several statutory trustee companies have got into trouble and have had to be wound up.

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The fees charged by statutory trustee companies could involve some or all of:

- an initial commission based on a percentage of the capital value of the fund
- a periodical commission based on a percentage of the income of the fund
- an administrative fee for each debit or credit entry
- an hourly fee for any paperwork

or some variation of that.

Beneficiaries under trusts administered by statutory trustee companies sometimes express great dissatisfaction with the arrangements.

Typically, such complaints can relate to:

- The relatively high level of their fees.

- Allegedly poor investment performance.

- The conversion of assets into cash when they could have been retained in their original state.

- Bureaucratic delays and red tape in providing money required by beneficiaries for personal expenditure items authorised by the will or trust deed.

- The thoughtless loss or destruction of items of great sentimental value (such as old photographs or letters) even though these may have had no commercial value.

Because of such problems some testators or settlers prefer to use joint executors or trustees, being a statutory trustee company and a relative. The former is chosen because of its permanent existence and its resources to look after the bookkeeping and taxation aspects. The latter is chosen to provide a more human touch.

Attributes of an ideal Trustee

In the case of individuals the persons to act as trustees of a family trust may have been appointed to those positions primarily because of their connection with the family – for example, the father who, desiring to provide for his children, has supplied (and, probably, is continuing to supply) the bulk of the resources held by the trust.

However, not all fathers in this situation have the time or in the inclination to act as trustees, or the necessary technical knowledge – for example, in regard to investment, accounting, taxation and legal aspects.

Furthermore, it may be desired to have additional trustees who can better act at arms' length and/or who can organise a replacement for an original trustee on that person's resignation, death or disability.

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Such an appointee should:

- have a high standard of integrity
- be willing to assume the responsibilities of trusteeship
- be able to act in a business-like manner in the best interests of the beneficiaries
- probably live in the area in which the family and/or the main trust assets are located
- be agreeable to respecting the confidentiality of the trust's and the family's affairs and not use knowledge of these for improper purposes
- not have any conflicts of interest
- preferably be likely to live long enough to be effective
- be a person who can be trusted both to carry out the intentions of those who set up the trust and to consider the reasonable wishes of the beneficiaries
- be able to devote the time needed for the task
- have some knowledge of the type of investments making up the bulk of the trust portfolio
- have competence in any other areas of relevance
- know when it is important to consult outside experts and when it is better not to waste the trust's money on seeking expensive external help needlessly
- be likely to be impartial in the event of any disputes amongst the beneficiaries
- have the skills to act as a mediator
- be able to negotiate appropriate deals as required — for example, temporary banking accommodation in the event of unexpected cash needs
- be able to assist with any other tasks appropriate to the family's special circumstances — for example, choosing schools for dependent children or liaising with the guardians of orphan children.

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Duties

The prime duty of the trustee of a typical family trust is naturally to observe the provisions of the trust deed. A new trustee should therefore take speedy steps to become familiar with that document, including all amendments.

The trustee also needs to become familiar with the nature of the trust property.

The trustee must not act in a vacuum — the trustee should always have regard to the objectives of the trust and the circumstances of the individual beneficiaries.

In practice the main obligations would include the following:

- to invest the trust fund in investments authorised by the deed
- to collect the gross investment income
- to pay all legitimate expenses
- to have appropriate cash management practices in place
- to maintain proper books of account
- to lodge income tax returns
- to pay any required income tax
- to protect and insure the assets of the trust
- to distribute or accumulate the nett income each year
- to stay in touch with the beneficiaries and as appropriate keep them informed.

A trustee is required:

- to set the short term and long term investment strategy and the asset allocation policy
- to make the day to day investment decisions, including in regard to new share issues and the like
- to undertake the periodical reviews of the investment portfolio
- to monitor the performance of any external fund managers used
- to manage any properties owned by the trust
- to negotiate as required appropriate borrowings and the periodical renewal of any loans facility.
- ro do the routine administration and bookkeeping (including banking investment income and preparing the tax returns)
- to ensure that trust assets are clearly identified as such
- to ensure that any payments or asset transfers are made to the right persons.

A trustee of a discretionary trust has, inter alia, to work out the best way of distributing the trust income each year. This may involve reconciling conflicting objectives and setting priorities.

It is important for tax reasons to distribute all income pertaining to each financial year within about two months of 30 June. Such a distribution does not actually have to be in cash — book entries supported by appropriate formal resolutions would be usually be sufficient.

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Investment aspects

Normally, a trustee is required to invest trust property using the same diligence and prudence as an ordinary person of business would exercise if the assets concerned were his or her own.

However, in a family trust context such a limitation would rarely be appropriate. A typical deed would therefore provide tat the trustee is authorised to invest as the trustee sees fit notwithstanding that the trust fund consists of trust moneys.

Such wording would, for example, authorise the trustee to make soft loans to family members to enable them to acquire their own housing or to finance a business.

Such a loan might, for example:

- be granted even if it would not meet normal commercial lending standards
- be offered at a concessional rate of interest
- be offered on the basis of relatively low periodical repayments
- be granted without insisting on a formal mortgage (thus saving the costs involved in documenting a security property).

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Some persons favour investment restrictions based on ethical considerations — for example, avoiding companies involved in alcohol, tobacco, gambling or uranium. However, unless the deed imposes limitations of this sort it would not be appropriate for a trustee to introduce them unilaterally. A trustee can, of course, have regard to ethical considerations, but this must not be at the expense of the beneficiaries.

For long term investors, such as most family trusts, any day to day price fluctuations on the stock exchange or even the less visible fluctuations in the property market are quite irrelevant.

When assessing investments regard should always be had to their future performance and not to their past. To illustrate, selling a good share which has gone up in value merely for the sake of realising a profit will rarely be a sound policy.

Different classes of beneficiary

An additional point will be very relevant for some trusts: if there are several types of beneficiary then the trustee has to maintain equity between them.

The most common example of this situation is the existence of certain beneficiaries who are entitled to only the income of the fund and of others who are entitled to only the capital.

The former would usually be best served by investing in high-yielding securities with little chance of capital growth. Other things being equal, the latter would be better off with low-yielding securities, which have a good chance of capital growth. An independent trustee would need to strike a fair balance between the two categories of beneficiary.

Income Tax

Note: The discussion which follows relates in the main to resident trusts and resident beneficiaries. It first of all deals with general principles and then with the specific rules which apply up to at least 30 June 2002.

The basis of taxing trusts

With some exceptions which are not relevant here a trust is not regarded as an entity for income tax purposes in Australia. Trusts are thus treated quite differently from companies. They are to some extent treated in regard to their beneficiaries in a similar fashion to partnerships in regards to their partners, but with some important differences.

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The trustee of a trust is required to lodge an annual tax return in much the same way as an individual, showing the income of the trust under various headings and certain other information. The liability for tax on income derived by a trust is, as far as practicable, levied on the beneficiaries receiving or entitled to receive the relevant income. It is then taxed in their hands, at their marginal rate of tax.

However, where the beneficiaries are minor or under some disability (or non-resident) the tax assessment will be issued to the trustee, effectively as the agent for the beneficiary concerned. Such assessments are issued to a trustee in the capacity as trustee and not in a personal capacity.

In the case of minors under the age of 18 a penal tax rate applies.

To ensure that tax is not being avoided by trusts choosing not to distribute income to beneficiaries in any financial year special provision apply to inter vivos accumulation trusts.

Under these provisions a trustee is liable for tax on any income "to which no beneficiary is presently entitled", effectively as agent for the trust estate (although in those circumstance the trustee also gets the benefit of any undistributed imputation credits).

For these reasons virtually all trusts which have been set up as investment vehicles for the general public invariably distribute to the hilt. Family trusts would normally wish to adopt the same strategy unless there were special reasons for acting differently.

Superannuation surcharge

Having regard to the 48.5 per cent penal tax provision any suggestions that trusts prefer to make loans rather than distributions to beneficiaries in order to stop them getting assessable income do not make sense in the context of tax avoidance, except in regard to reducing such income for high income earners otherwise affected by the superannuation surcharge.

Trustee resolutions

In the case of discretionary and unitised trusts making a distribution the equivalent of a company declaring a dividend – involves the trustee passing an appropriate resolution.

Such a resolution could take several forms – for example, setting out the entitlement of each individual beneficiary in dollar terms or as a percentage or as a mixture of both.

If dollar amounts are desired then it is advisable for the resolution to indicate these amounts for all but one of the intended recipients, and for the other beneficiary to be given an entitlement to the remaining balance of the total but without actually quantising it.

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This will ensure that the trust's capital stays intact and that no income remains with the trustee as income to which no beneficiary is presently entitled in the event of a clerical mistake by those preparing the tax return or should an adjustment be made by the Taxation Commissioner.

The format suggested is also designed to facilitate the completion of the "statement of distribution" which is part of the trust's tax return each year.

The columns actually needed by each trust will naturally depend on the particular circumstances, For example, trusts which receive franked dividends will need a column for these and a further column for the attached imputation credits. Similarly, trusts which receive foreign income will need a column for that on a gross basis and a further column for the foreign withholding tax deducted from it.

Trusts with non-resident beneficiaries will need to have columns whi.ch allow for the implications of Australian taxes including withholding tax on certain categories of income:

- dividends (often taxed at 15 per cent under double tax agreements)
- interest (often taxed at 10 per cent under double tax agreements)
- foreign income (exempt under section 23(r) of the income Tax Assessment Act 1936 as "income derived by a non-resident from sources wholly out of Australia")

Although it is no longer compulsory to attach a copy of this resolution to the return lodged with the Australian Taxation Office such a procedure is recommended for all but very simple cases.

Section 101 of the Income Tax Assessment 1936 deals with the exercise of a discretion by a trustee in favour of specified beneficiaries. However, the section is silent as to when this needs to happen.

Some trustees are interpreting this silence as meaning that a determination needs to be made before the end of the relevant financial year, but such a course of action would often mean that pertinent information regarding both the performance of the trust during the year and the financial affairs of the potential beneficiaries would not yet be available — thus prejudicing the trustee's ability to make a sensible decision.

Income Tax Ruling IT 328 does, however, indicate that in practice a trustee is allowed two months from the end of the financial year to make the determination.

The trustee's discretionary power extends to deciding which beneficiary is to get which component of the total distribution. As explained later it is fundamental tax rule that items passing through a trust fund always keep their distance.

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Different components can thus be passed on to different recipients and the trustee's resolution needs to deal unambiguously with that matter.

Loan accounts

Distributions do not actually have to be made in cash, as book entries crediting the relevant amounts to loan accounts suffice, provided only that the necessary formalities have been complied with.

It follows from the above that a mere lack of liquid resources — which is sometimes a problem in practice if a trust find is fully invested and/or where it gives priority to repaying external debt — need not prevent the declaration of a distribution.

It is probably simpler all round no to pay interest on such loan accounts. Naturally, the absence of interest overall results in a higher pool of funds becoming available for trust distribution in future years. The absence of interest for individual loan accounts can be one of the factors taken into account when individual distributions are decided on each year.

Other loans to a trust from related parties can, if desired, also be grated on an interest-free basis, the advantages being that:

This is administratively convenient.

There can be a tax saving all round if the lender has a higher marginal tax rate than the beneficiaries of the borrower trust.

The net interest foregone can be regarded as a form of deliberate gifting to the trust.

The meaning of "Income"

As a matter of philosophy the Australian income tax legislation seeks to tax profits. However, as a matter of law, tax is actually imposed on each taxpayer's "taxable income" (this being the "assessable income" less the "allowable deductions").

All of these terms are defined in the Income Tax Assessment Act 1936 — broadly speaking "assessable income" refers to gross receipts and "taxable income" to nett receipts after allowing for expenses. The two concepts, "profits" and "taxable income", are similar but not quite identical.

Accountants rely on certain accounting standards to establish what can loosely be called the profit of an enterprise, technically its "accounting income". For a number of reasons — including timing differences, non-allowable expenses and various statutory concessions — the taxable income of an enterprise in any financial year can be either greater or less than its accounting income.

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Trust deeds will usually have their own specific definitions of "income" for purposes of the trust and this may produce figures which are different yet again.

Two distinct categories of beneficiary can sometimes be involved in a family trust — those entitled to distributions made out of income and those entitled to distributions made out of capital. Where this is the case the relevant definitions can be very important.

In practice deeds in uncomplicated situations usually allow the trustees to treat as "income" for trust purposes any amounts which are regarded as "assessable income" for tax purposes.

If the net income for trust purposes and the taxable income can be kept in line then this is certainly convenient administratively. It also avoids the problems of how to handle any discrepancy equitably.

If this cannot be done then two distinct possibilities arise:

The trust distributions are greater than the taxable income of the trust. The excess then becomes a tax exempt component of the distributions in the hands of the beneficiaries.

The trust distributions are less than the taxable income of the trust. It is then probably best to notionally include the shortfall in the assessable income of all beneficiaries on a proportionate basis, rather than to have it taxed at a probably higher rate as income to which no beneficiary is presenting entitled.

One common item needs special mention in regard to the above topic. Trusts which invest in Australian shares will often receive franked dividends. Attached to these will be imputation credits. From their very nature such items are never received in cash, but their value can be passed on to beneficiaries.

In fact, if the imputation credits are not passed on then these would constitute income to which no beneficiary was presently entitled, although the trustee would also get the benefit of the credits themselves.

Where the deed does not prevent such a course of action it is probably simplest:

to treat the total imputation credits as part of the total income of the trust fund; and
to regard an equivalent amount as having been distributed to some appropriate beneficiaries.

Those expenses which are incurred at the time a loan is granted can be claimed pro rata over five years or over the intended duration of the loan, whichever is the shorter. Amounts of less than $100 can, however, be claimed in full in the relevant year.

Expenses incurred in discharging a loan can be claimed in the year concerned.

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types of trust

From its nature, investment in property gives rise to a number of ongoing deductible items apart from those of a more general nature already mentioned above – for example:

- Depreciation.
- Municipal rates.
- Water rates.
- State land rates.
- Fire and public liability insurance premiums, and so on.
- Repairs and maintenance (but not renovations).
- Agents' commission for rent collection and management.
- Agents' commission for arranging new leases.
- Advertising costs when seeking new tenants.
- Body corporate levies.
- Cleaning charges.
- Arbitration fees in relation to rent disputes.
- The cost of property journals.

Such items are deductible to the extent that they are the responsibility of the landlord and are not reimbursed by tenants.

The expenditure and the corresponding income do not have to occur in the same financial year.

Pre-paid interest, where the period covered is up to 13 months, can be claimed in the financial year in which it is paid (under Sections 82KZL to 82KZO).

If the allowable deductions exceed the assessable income of any year then the trust has no taxable income in respect of that year and a "tax loss" is said to be incurred.

A fundamental feature of the tax law is that all items flowing through a trust keep their character. Thus a dollar of franked dividend received by a trust gives rise to a dollar of franked dividend received by a beneficiary when it is included in a trust distribution to that beneficiary.

Similar remarks apply in respect to the associated imputation credits and to various other categories of income including:

- interest
- rent
- unfranked dividends
- foreign income
- foreign tax credits
- realised capital gains which are tax exempt because they relate to assets acquired (or deemed to have been acquired) by the trust before 20 September 1985 (the commencement of capital gains tax, a tax which is discussed in greater detail later).
- realised capital gains which are tax exempt by virtue of indexation (only the excess of the proceeds over a cost price adjusted for inflation up to 30 September 1999 is subject to capital gains tax) or by virtue of discounting by 50 per cent (as the case may be)
- realised capital gains which are taxable
- tax deferred income
- tax-free income.

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This aspect needs to be borne in mind by trustees of discretionary trusts when deciding to whom to distribute income. One major advantage of such trusts is that these different components can, if desired, go in different directions.

For example, passing interest income on to a non-resident beneficiary may be particularly attractive because of the low 10 per cent withholding tax rate which is generally available.

The distribution of imputation credits needs to follow the franked dividends to which they are notionally attached. They cannot go in a different direction.

Any imputation credits passed on a beneficiary which is a corporation are treated in the same way as imputation credits received by that corporation from direct share investments — in other words, they do not reduce tax at the company level but they can be used by the company to declare franked dividends to its own shareholders.

In some cases the specific provisions of a trust deed may require capital gains to be distributed to different beneficiaries from those entitled to income of a revenue nature.

This could result in higher taxes in the aggregate, for example, those receiving the capital gains have no capital losses from their other activities which could be used as an offset, while at the same time those not receiving the capital gains happen to have such capital losses.

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One further aspect of beneficiaries getting the benefit of any imputation credits which relate to their distributions needs special mention: since 1 July 2000 such credits if not applied against the beneficiaries' other tax obligations can attract a cash refund from the Australian Taxation Office.

Beneficiaries receiving distribution involving realised capital gains which are taxable can treat them in the same way as such items incurred directly. They can thus use them to offset capital losses of the current year or capital losses carried forward from earlier years.

Note: The above references to capital gains tax assume that the family trust is a normal portfolio investor, as distinct from a share trader. Different rules apply to traders – for example, they do not ever get the benefit of indexation under the "grandfathered" rules, but on the other hand they can offset capital losses against revenue gains.

Losses

If the nett income of a trust is negative – in other words, if it is running at a loss – then that loss cannot be distributed. However, the loss can be carried forward and offset against the income of subsequent years.

Capital losses can in a similar way be carried forward and offset against the trusts' capital gains of later years.

The significant difference here between the tax treatment of a trust and that of a partnership should be noted. Partnerships are always deemed for tax purposes to have distributed both capital and revenue gains and losses to their partners each financial year (whether or not they have actually done so in cash). The recipients can then use any such losses in the same way as directly earned losses, as offsets to their other income.

Information required by beneficiaries

The trustee would normally also supply appropriate details of the above mentioned separate components of income to the beneficiaries concerned, either with each distribution cheque or more probably at the end of the financial year.

If any beneficiaries are not comfortable with concepts such as dividend imputation then it would be helpful if the trustee also gave them an explanation of how these items need to be treated for income tax and/or social security purposes (imputation credits need to be reported as income for tax but not under the social security means test; in addition they qualify for an income tax rebate).

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Personal exertion income

The above analysis envisaged a traditional family trust, which owns assets and earns income from those assets. The assets concerned could be in an investment portfolio and/or in a business or farm. In the latter cases the total return on the assets would no doubt include an element of personal exertion income (resulting from the use of labour or management skills rather than the use of capital).

However, care should be taken not to extend that principle too far. It is, for example, unlikely that the taxation authorities would accept that an inanimate trust is capable of earning income as (say) a medical practitioner or an artist.

Non-residents

Some additional tax rules apply to non-resident trusts, which derive income in Australia — for example, they need to appoint a public officer who is a resident. Additional tax rules also apply to resident trusts with non-resident beneficiaries — for example, in regard to the need to deduct withholding tax from dividend and interest payments.

Furthermore, a different tax rate applies to non-residents in respect of certain types of income. They are not subject to the Medicare levy.

Family trust elections

One of the many complications to the tax law introduced in recent years relates to family trust elections. It governs 1996-1997 and later tax returns. Such elections are not compulsory, but they confer certain advantages in relation to losses carried forward and franking credits passed on to beneficiaries in respect of shares acquired after 31. December 1997.

They also confer certain disadvantages in regard to distributions down the track and distributions to persons outside the family group. Elections need to be made on a special form obtainable from the Australian Taxation Office. Once made they are irrevocable for discretionary trusts but not for non-discretionary trusts.

A “family group” is defined by reference to a “primary individual” named on the form. In many cases the best individual for such a nomination will be a family member in the generation after that of the person who contributed the bulk of the resources, as this maximises the number of relatives in other generations who can be brought into the group.

There are no corresponding provisions affecting family companies.

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Capital Gains Tax

Background

Australia has had a formal capital gains tax since 1985, although many people still do not seem to understand how it works. Its provisions are of considerable relevance to family trusts and their beneficiaries and also to persons who are still deciding whether or not to use a family trust structure.

The comments, which follow are no more than a brief summary of what is quite a complex code.

Strictly speaking, capital gains tax is not a separate tax. Rather, it is levied as part of the overall income tax system. However, because of its many special features it is convenient to discuss it as a subject in its own right. The relevant legislation.

Part IIIA of the Income Tax Assessment Act 1936 (Sections I60AX to 160ZZU), affects realised capital gains and losses.

In contrast, unrealised gains by portfolio investors as distinct from traders are not subject to taxation. Realised capital gains in the hands of individuals are also subject to the Medicare levy. However, as capital gains are subject to a number of special rules relating to aspects such as

- indexation (up to 30 September 1999)
- averaging (for disposals before 21 September 1999)
- discounting (as from 21 September 1999)
- provisional tax (up to 30 June 2000)
- “pay as you go” instalments (as from 1 July 2000)
- the offsetting of capital losses
- the exemption of gains relating to assets acquired before 20 September 1985
- the treatment of deceased estates

it is often convenient to refer loosely to a capital gains tax or CGT.

The main points can be summarised as follows:

Averaging has been abolished for disposals after 21 September 1999 (thus all realised gains are no taxed at the taxpayer’s marginal rate).

Assets acquired after 21 September 1999 and disposed of at a capital gain after at least on year will be taxed at 50 per cent of the nominal gain (in the case of individuals) and at 66% per cent of the nominal gain (in the case of superannuation funds), with the 1 00 per cent ratio continuing to apply in the case of companies (in the case of individuals this discounting effectively reduces the marginal tax rates which apply to realised capital gains).

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Assets acquired between 19 September 1985 and 21 September 1999 and disposed of at a capital gain after at least one year can be taxed, at the option of the taxpayer, either on this "new" basis (using the specified proportion of the nominal gains) or on the "old" basis (using the full indexed gains, but with indexation frozen as at 30 September 1999).

Assets of either kind disposed of at a capital gain after less than a year will continue to be assessed in respect of the fill unindexed gain.

Assets of either kind disposed of at a capital loss can have the full nominal losses offset against the full nominal capital gains before discounting as explained above or the capital gains net of frozen indexation, whichever is more favourable to the taxpayer.

Revenue losses, including those arising from negative gearing transactions, can still be offset against capital gains — but not vice versa.

Administratively, this means that investors have to keep track, not of two distinct classes of assets as before, but rather of three:

- those acquired up to 19 September 1985
- those acquired 20 September 1985 to 21 September 1999
- those acquired from 21 September 1999 onwards.

In tax terms this produces a mixed picture. Investments which enjoy large capital appreciation in a short term benefit substantially from the halving of the tax rate for individuals. But the tax bills will increase for post-September 1999 investments with values which happen to rise at less than twice the rate of inflation. It is now possible to pay tax even while making losses in real terms.

Realised capital losses (but, illogically, always without indexation) can be offset against realised gains of the same or a subsequent financial year — but not against ordinary income. There were originally two features of the capital gains tax system which made it fairer than the income tax levied on revenue transactions.

The first was the partial recognition of inflation. Only real rather than nominal capital gains were taxed — although quite illogically and unfairly this recognition did not extend to capital losses.

The second was the concept of averaging. This minimised the effects of irregular receipts of money pushing people into higher tax brackets than was really warranted by their overall position.

Capital gains tax has one useful feature for investors — within limits they can influence the timing of transactions to best suit their own circumstances.

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Most investors are not in the business of (say) share trading and any profits which they make by buying shares at one price and selling them at a higher price are regarded as “capital gains” for income tax purposes. These are taxed under the above-mentioned special provisions of the legislation instead of as normal income of a revenue type.

Generally speaking, any assets acquired before the introduction of capital gains tax on the evening of 19 September 1985 remain outside the scope of the capital gains tax legislation imposts. Assets acquired after that cut-off date give rise to a capital gains tax liability, buy only if and when they are sold or otherwise disposed of unrealised capital gains remain exempt and unrealised capital losses remain unclaimable.

Indexation

For assets held for less than 12 months this liability is based on the excess of the sale price (net of selling expenses) over the original purchase price (including all acquisition costs). The purchase price adjusted for associated capital costs is referred to in the legislation by the technical term “cost base.”

Where indexation is available, for assets held for longer periods, this cost base is indexed for inflation, thus producing a lower tax liability. The Consumer Price Index (CPI) figures for the relevant calendar starting quarter and the September 1999 quarter are used for this purpose.

The cost base can consist of more than one component, as for example when contributing shares are purchased subject to calls paid later on or when capital improvements are made to a property. However, expenses of a revenue nature, such as rates, taxes, repairs, interest, and so on, are disregarded. For assets purchased with the aid of borrowed funds the indexation factors are applied to the gross value of the assets, not to the nett value allowing for the loan. This is quite generous.

Capital Losses

The capital gains tax legislation just described for capital gains situations also applies to capital loss situations, but with some important differences. In particular, the purchase price (cost base) of assets sold at a loss (or even at a gain which is not big enough to be subject to capital gains tax after allowing for inflation) is never indexed.

Furthermore, as described above, capital losses can be offset against capital gains, but they cannot be deducted from normal income. Unused capital losses can, however, be carried forward indefinitely and offset against capital gains in subsequent years.

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Transaction costs

Brokerage and stamp duty on purchases of stock exchange investments and legal fees and stamp duty on purchases of property investments are regarded as part of the capital cost and are therefore not deductible as expenses incurred in the earning of assessable income. However, such items enter the capital gains tax calculations by lowering the capital gain, which would otherwise have applied.

These items, written up by the usual indexation factor where applicable, can thus effectively become deductible at the time of realisation (although this may then involve a different set of beneficiaries in the family trust context and also a tax rate which is different from that which would have prevailed if such items had been regarded as revenue items). Furthermore, there is no allowance for interest.

Brokerage and stamp duty on investment sales and agents' costs and legal fees on property sales enter the capital gains tax calculation in a similar way, except that naturally indexation is not applicable for these.

Transaction dates

It will be obvious from the above description of the system that the precise dates of transactions can be important for capital gains tax purposes. Trustees thus need to keep appropriate records, possibly for very long periods (from the acquisition of an asset until five years after its disposal).

Exempt transactions

Certain assets fall outside the capital gains tax net — for example:

In the case of individuals, the sole or principal home, but not a second or holiday house or property held by way of investment. This is a concession introduced for electoral rather than economic reasons. These rules may well change at some time in the future, especially for very valuable homes; this would probably not result in any retrospective liabilities. However, homes owned by family trusts do not qualify.

Motor vehicles. Their exemption is not really a concession, as in most cases cars deteriorate in value over time and thus overall the revenue benefits from their exclusion from the tax nett. However, the exemption also covers vintage and antique cars and could be used a legitimate loophole by collectors of such items.

Life insurance policies, friendly society policies and superannuation. These are exempt in the hands of the original policyholder or member, as taxes on capital gains are paid by the institutions concerned. Existing life policies can, however, be on-sold to arms' length investors (including family trusts) as an alternative to surrendering them, in which ease the purchaser would be subject to the same capital gains tax rules as in respect of any other investment.

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Assets left by will or intestacy

The death of a person is not regarded as the disposal of that person's assets for capital gains tax purposes, but special provisions apply from that time on. The incidence of capital gains tax is deferred until the assets are disposed of by the executor or administrator or — possibly many years later — by the beneficiaries. Transfers of assets by an executor or administrator to beneficiaries are also not regarded as disposals for capital gains tax purposes.

In the case of assets acquired before 20 September 1985 these are treated as having become assets acquired after 19 September 1985 by the executor or administrator (if that person disposed of them) or by the beneficiaries. The acquisition date would be the date of death and the cost base would be the market value prevailing at that date.

No tax is payable at the time of death, but the "before 20 September 1985" status is lost from that time on. Realised capital appreciation as from the date of death, to the extent that it is in excess of indexation (where this is available), thus attracts capital gains tax.

In the case of assets acquired after 19 September 1985 these keep their status and are treated as assets acquired thus by the legal representative (if that person disposes of them) or by the beneficiaries. The acquisition date would again be the date of death, but the cost base would be the original cost price indexed to the date of death or 30 September 1999, whichever is the earlier. In order words, such assets are regarded for capital gains tax purposes as a continuation of the deceased investor's holdings, with no tax falling due at the time of death.

Gifts

The tax treatment of gifts inter vivos is very different from the treatment of legacies described above.

The same principles apply both to gifts to individuals and to gifts to trusts.

Gifts are not regarded either as income or as capital gains in the hands of the recipient. However, in the case of a gift not made in cash the transaction would for capital gains tax purposes be treated as a disposal of the asset by the donor for a consideration equal to its market value at the time — the same rules as applies in the case of all disposals for inadequate consideration (Section I6OZD(2) of the Income Tax Assessment Act 1936).

The recipient is then, quite consistently, regarded as having acquired the relevant asset at a cost base equal to the same market value.

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Scrip for Scrip

The permanent exclusion from the scope of the capital gains tax legislation of all assets held at its commencement was a relatively generous concession on the part of the authorities, although its value was somewhat reduced by the absence of rollover provisions.

However, this has now been partially remedied. Since 10 December 1999, rollover relief for "scrip for scrip" considerations received in takeover situations has, at the option of the investor, been available for shares acquired after 19 September 1985 which would otherwise have given rise to a capital rise to a capital gain (but not to those which would otherwise have given rise to a capital loss). (In this context "scrip for scrip" refers to shares for shares, options for options, and so on).

However, the benefit of owning shares with "before 20 September 1985" status does not survive such transactions.

If the consideration is partly in shares and partly in cash then an apportionment must be made, as only the part of the consideration which relates to the shares qualifies for the rollover relief

Transfers of assets

The desirability of transferring specific asset into a family trust should have regard to the rules outlined above. Consider, firstly, an asset owned by (say) a father and acquired by him after 19

September 1985 and before 21 September 1999. If he gives this to his son outside a family trust arrangement then that constitutes a disposal for capital gains tax purposes. If the asset has appreciated by more than indexation to 30 September 1999 then that would incur capital gains tax.

If, in due time, the son repeats the process by giving the asset to his own son, then another lot of capital gains tax could arise, and so on, each time such a transfer takes place.

In contrast, if the father gives (or sells) that asset to a discretionary family trust then only the first lot of capital gains tax would apply.

The benefit of ownership after that time could be passed on to successive generations without triggering off any further capital gains tax until such time as that particular asset finally left the family trust — although, in distinction from the above scenario, until that time the beneficial ownership of the asset would be with the beneficiaries generally and not with a specific son.

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If instead of using either of the above alternatives, the father kept that asset during his lifetime and then left it to his son on his death, and his son similarly passed it on to his own son on his own death, and so on, then no capital gains tax at all would be triggered until such time as that particular asset finally left the family.

This third strategy could thus be attractive, but only in some circumstances, notably for any assets which have appreciated significantly already, where the value of the capital gains tax deferment may exceed the value of any tax gains to be made from using a family trust structure.

Consider, secondly, an asset owned by (say) a father and acquired by him before 20 September 1985.

The first inter vivos transfer, whether directly to the son or to the family trust, remains outside the capital gains tax net. After that the position is as above.

There can thus be considerable attraction in the father keeping such an asset himself and in not having it converted to the deemed “after 19 September 1985” status for as long a period as possible — that is, until his death.

Some diagrammatic examples

Mr and Mrs John and Sue ACME Family wish to invest in a $150,000 rental property and $50,000 of blue chip dividends. They have $50,000 deposit and plan to borrow the rest and negative gear. John earns $90,000 per year from his job and Sue has no taxable income. The following structure has the ability of allowing negative gearing in John’s name, capital gains to be distributed to Sue and following repayment of the loan and redemption of John’s units, all income to be distributed to Sue.

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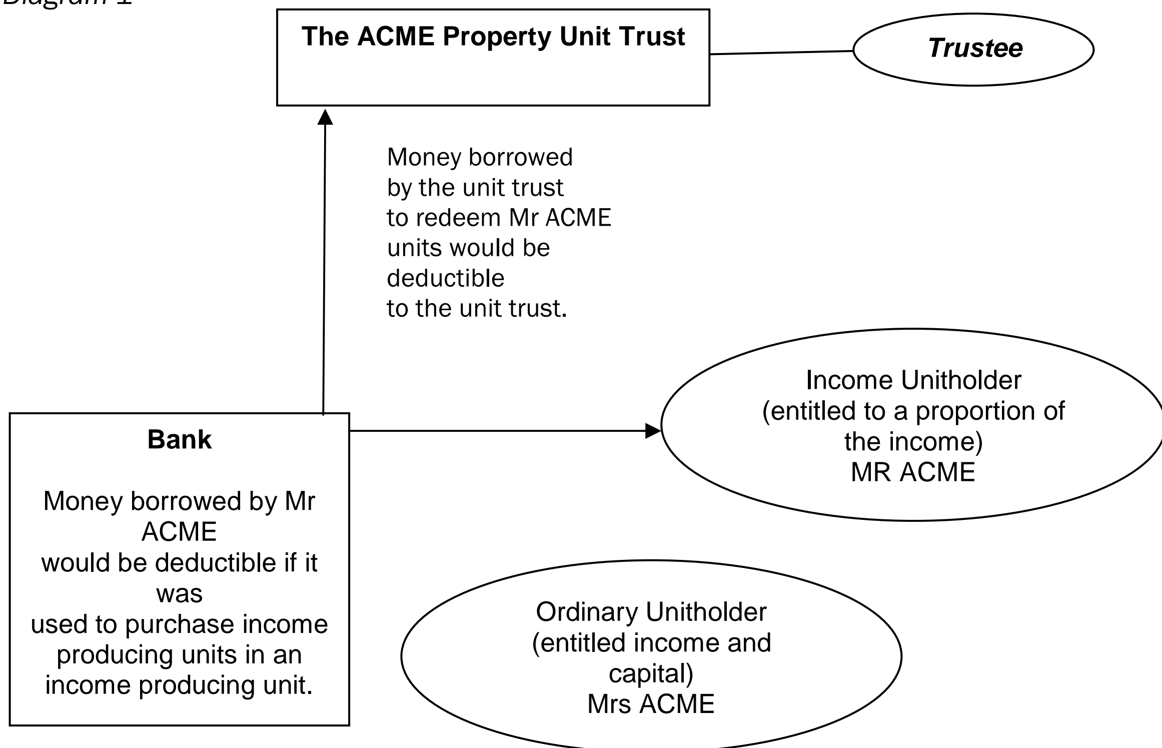
Diagram 1



The increased use of trusts as a vehicle for family investments or business structures has meant that advisers, potential trustees and beneficiaries should be aware of variations on the standard unit and discretionary trusts. The use of hybrid• or class trusts to provide more flexibility for superannuation, taxation and asset protection, should be considered by every practitioner and client. There are two important factors that should be remembered when considering a trust arrangement. Who and for what period should be entitled to income and capital and who and how to control such entitlements.

The issue of control may be left up to the trustee or engrossed within the deed of settlement (trust deed). There is greater flexibility achieved if total entitlements to both income and capital distributions are left to the discretion of the trustee. Unfortunately, commercial considerations and legislative requirements mean that certain beneficiaries would require certain fixed entitlements. For example, if a capital vested trust is to comply with section 1 02AG(2A) of the Income Tax Assessment Act, then all capital must be distributed to the certain capital vested beneficiaries. Surviving spouses however, may be entitled to income only as in diagram 2.

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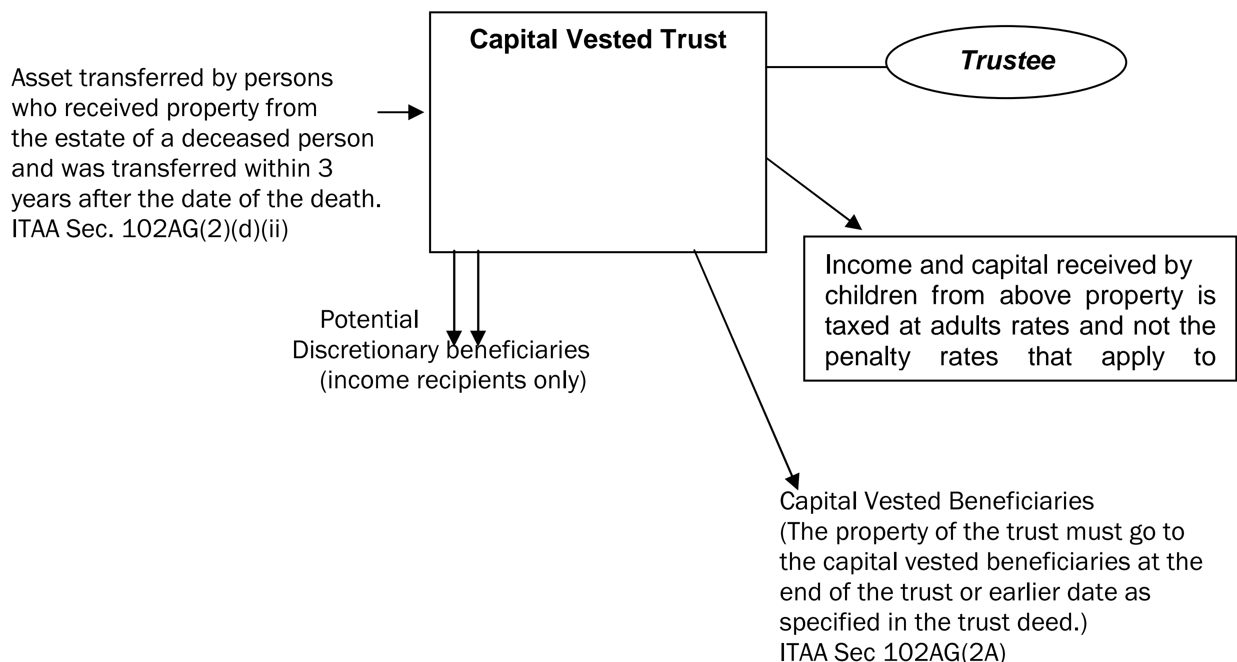
Diagram 2



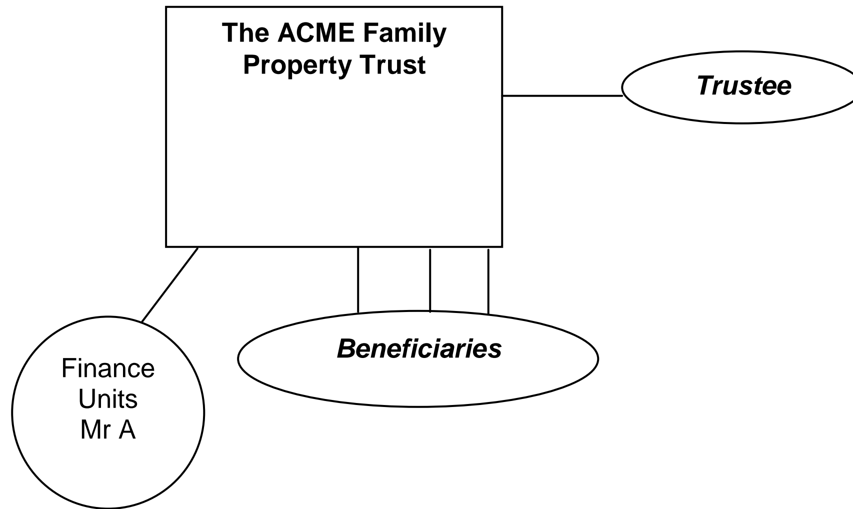
As each investor and investment are different there is no one right structure, it is suggested that if the investment will result in capital growth and for flexible distribution reasons, a discretionary trust should be used. If there is to be a borrowing then a hybrid discretionary trust should be used.

Hybrid Trusts

A hybrid trust occurs where different entitlements to either income or capital are allocated to different beneficiaries. A very flexible investment structure where a borrowing is to occur is the hybrid discretionary trust. As shown in diagram 3, one beneficiary is entitled to a certain proportion of the nett trust income in proportion to their subscription monies. The other beneficiaries are subject to the trustees discretion with the remainder net income however, distributions of capital are at the discretion of the trustee to those beneficiaries entitled to such distribution. Much care needs to be taken with the use of hybrid discretionary trusts to ensure that:

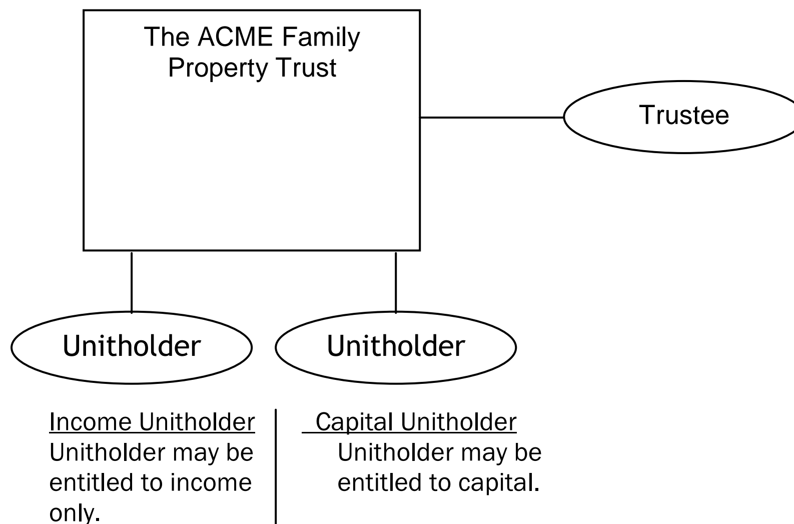
- The interest on any loan to acquire finance units is deductible (Refer 1T2684).
- Capital gains tax considerations are reviewed (Refer TD40)

Diagram 3



Another variation of a hybrid trust is where one beneficiary may be entitled to income and the other to capital as in diagram 4

Diagram 4



<u>Income Unitholder</u>
Unitholder may be entitled to income only.

<u>Capital Unitholder</u>
Unitholder may be entitled to capital.

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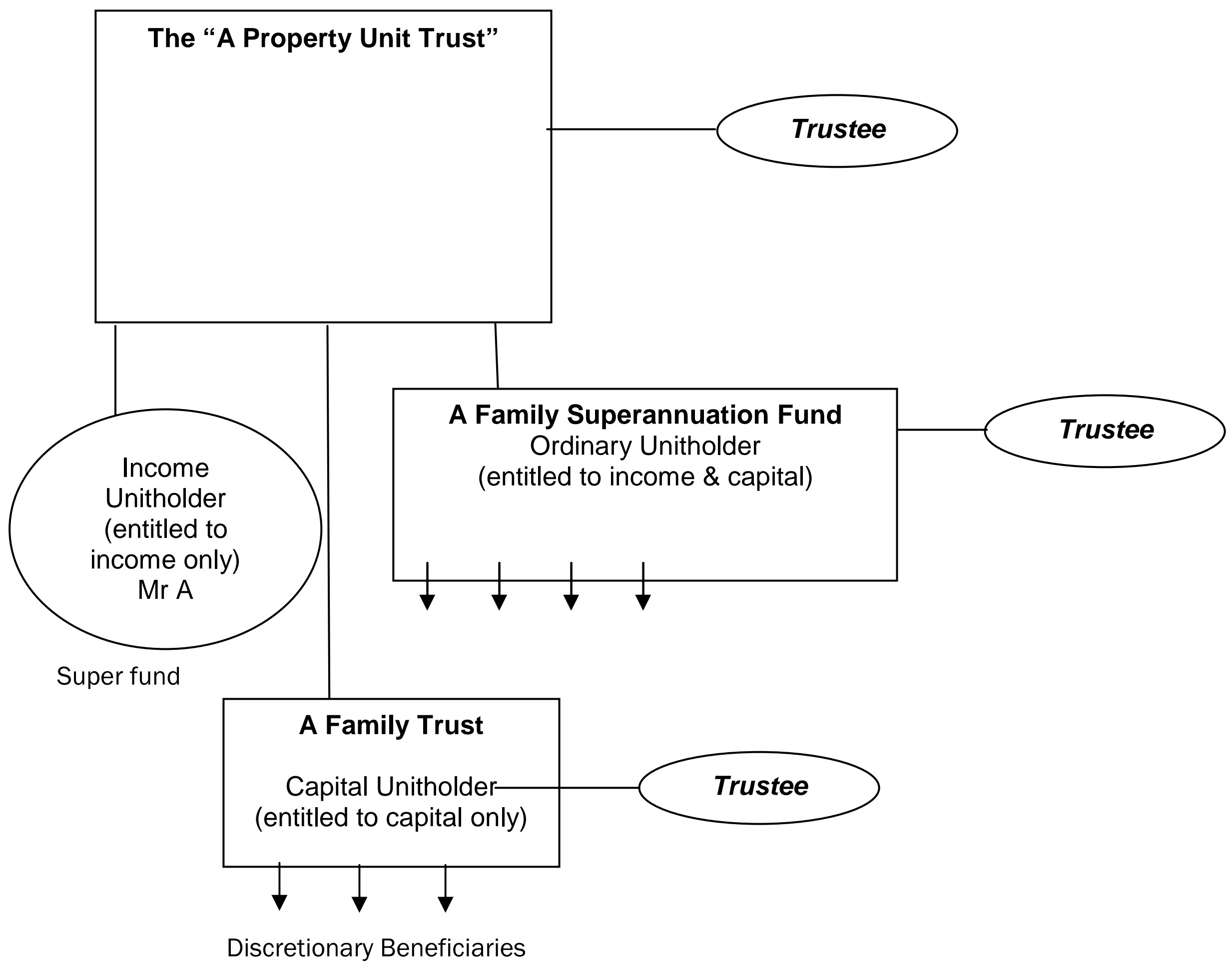
types of trust

Regardless of what the trust is called, it is the rights & restrictions of beneficiaries. There are many taxation consequences of hybrid and class trusts and some have been addressed in diagram 5

Diagram 5



'Trust Estates'

Interest on borrowings by a trustee is deductible if the borrowings finance the discharge or reduction of any of the following obligations, again subject to the restriction mentioned in paragraph 6:

a. a liability to a lender of money which, at the time of the replacement borrowings, is being applied to the assessable income producing purposes of the trust estate;

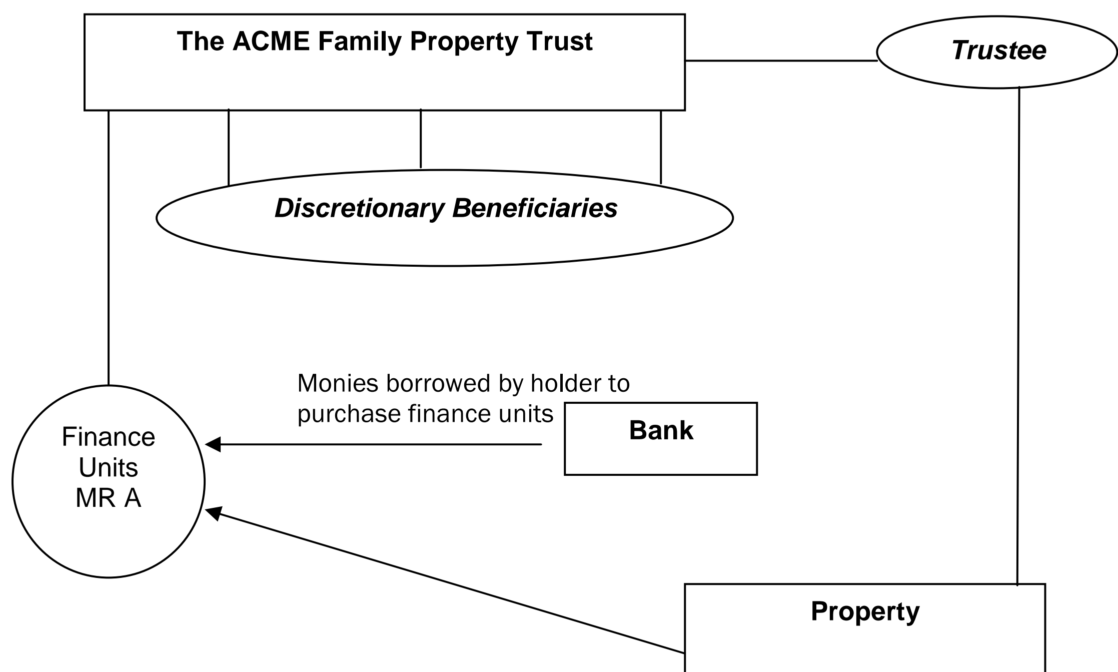
b. a liability to a trade creditor;

c. an obligation to make a payment to a beneficiary of the trust estate, under the terms o/the trust or by agreement between the beneficiaries, in reduction or extinguishment of the beneficiary's interest in the corpus of the trust estate; and

d. a liability to pay a beneficiary a share of the nett income of the trust estate

I would draw attention to (d) above which entitles a trustee to a deduction if the borrowings finance the discharge or reduction of a liability to pay a beneficiary a share of the nett income of the trust estate. Remembering that a unit is a chose in action represented by a bundle of rights, a beneficiary may be entitled to a share of net trust income. Therefore a borrowing by a trustee to redeem income units would be deductible to the trustee, as in diagram 3.5.2. 1 would advise that capital gains be considered however if the unit entitlement is to income only and not capital growth or distribution then capital gains after allowing for inflation should be minimal.

Diagram 6

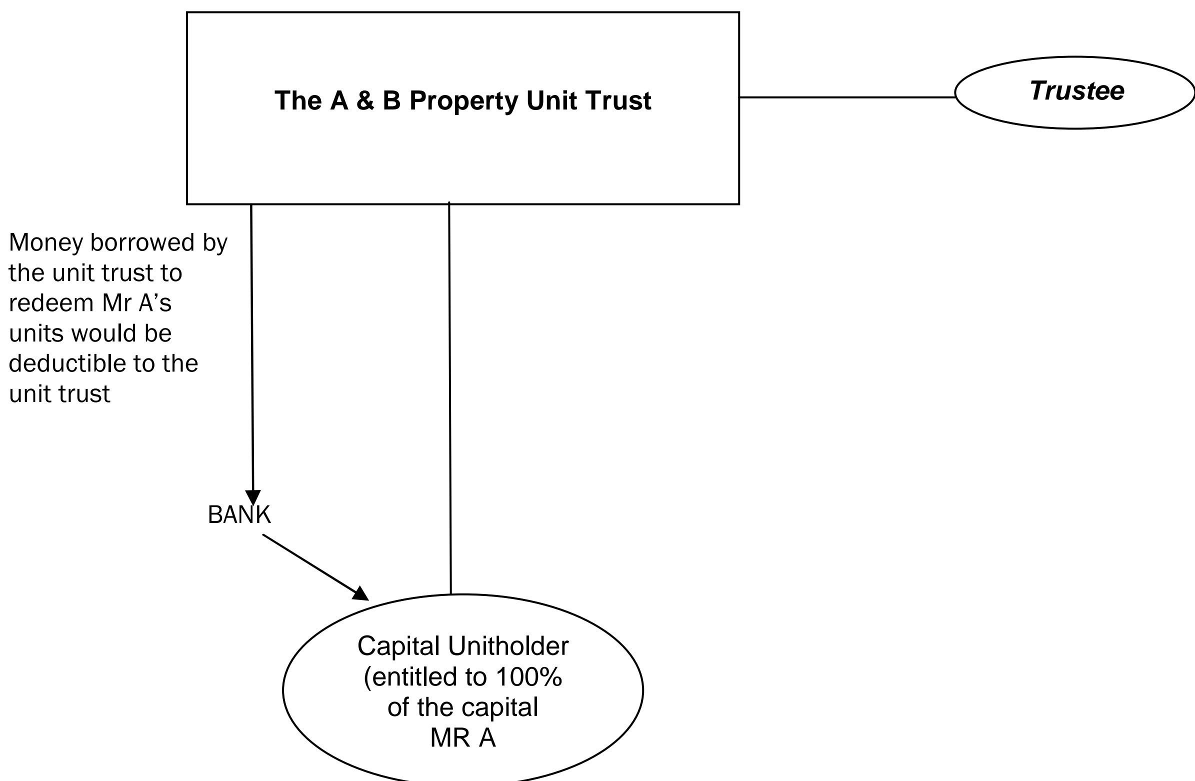


NOTE: Refer TD4O Capital Gains: What is the treatment where units in a unit trust are issued or redeemed by the trustee?

To actually apply the principles in practice would require an example. Mr & Mrs A wish to purchase a rental property using borrowed funds for investment purposes and to provide for the future of their children. A discretionary or unit trust is established and Mr A applies for and is issued income units. Mr A borrowed the funds to purchase income units in the trust. He therefore should be entitled to a deduction on the interest on the loan under Section 51(a) of the ITAA and I refer IT2684 and 1T25 12. If the trustee, following and application to redeem the units being sent from the unitholder, redeemed the units, as in diagram 7 using borrowed funds then this loan would be deductible.

Diagram 7

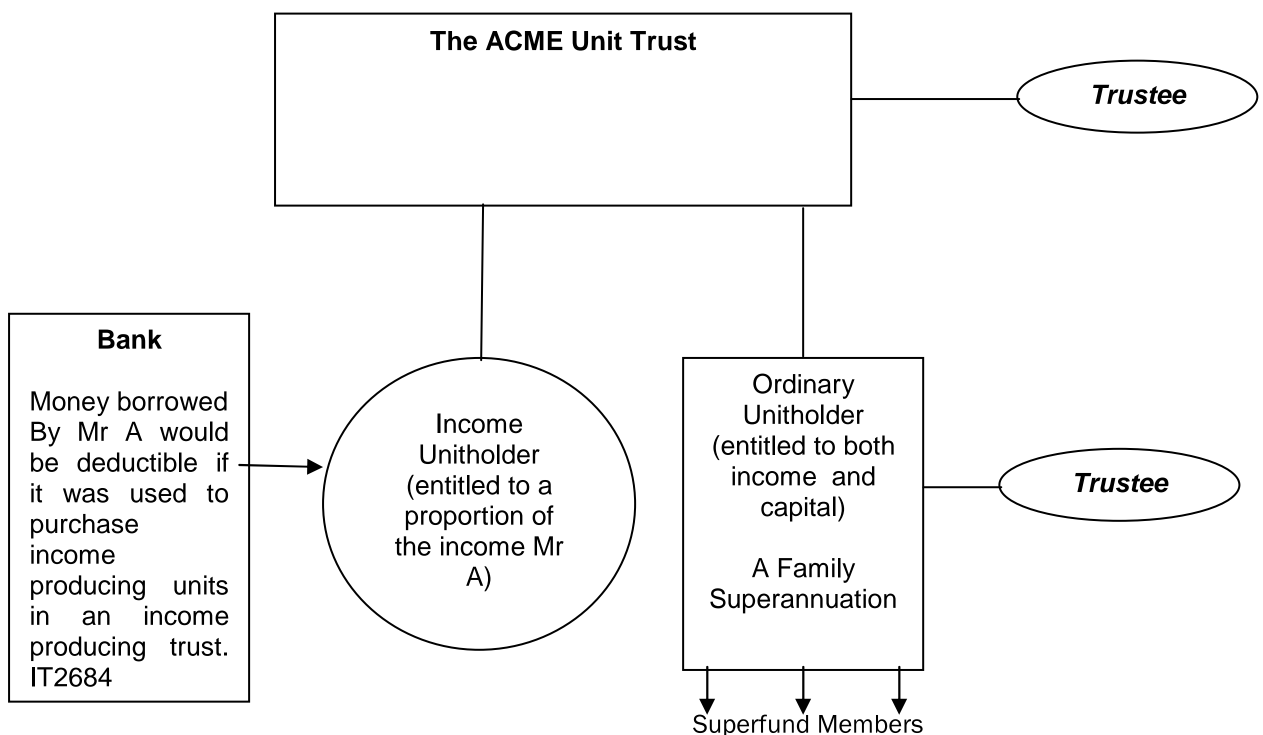
The purpose of the borrowing by the trustee is paramount in determining deductibility on the loan however the application of the funds by Mr A is of no consequence and therefore has no determination upon the trustee's entitlement to a deduction.



Superannuation Funds

Superannuation funds are still a very viable option. Unit trusts are a popular means of investing super monies as they are not subject to the same guidelines as super funds (i.e. unit trusts may borrow funds where superannuation funds are not permitted to borrow). If a borrowing is required and the investor has a self-managed super fund, the most tax efficient structure is' set out below at diagram 8 (this method is now superseded if the super fund is the controlling unit-holder and the other equal or majority partner is not an unrelated entity)

Diagram 8



Following the popularity of self-managed superannuation funds, there is a great deal of interest in the most suitable structures available for investment of superannuation funds whether it be in property, equities, business, antiques or a combination of investments. It is not the purpose of this paper to address the specific types of investments and their acceptability under Sections 69-84 of the MS Act (In-House assets) and Section 109 of the 515 Act (non-arm's length investments) however, it is how investments may be structured and the need for flexible planning. However, following the Swiss Chalet case (case 43/95), the Bananas in Pyjamas case (ease 23/96) and Case 28/96 much care needs to be taken.

The first issue to consider is the ability of superannuation funds to invest in unit trusts. In Trevisan & Anor (Trustees of Forli Pty Limited Superannuation Fund) v FC of T 91 ACT 4416 the Federal Court overruled the decision of the Administrative Appeals Tribunal reported as Case X70, 90 ATC 537, where the Tribunal disallowed the trustee's objection to the Commissioners view that the investment in a unit trust whereby the trustee was also the trustee of the employer sponsor (a family <-‘: trust), was a breach of the in-house asset rules. The Federal Court found that the acquisition of units in the trust was an investment in the real estate and other property the subject of the trust deed. It was not an investment in the trustee of the unit trust and therefore was not a breach of the in-house assets rule. Care however, should be exercised regarding the trustees of both the unit trust and superannuation fund. Where the trustee of the super fund is also the trustee of the unit trust and also the sole unit-holder as in diagram 5.1.1, then it may be argued that no unit trust exists.

This may be avoided by either having more than one unitholder or a different trustee. Despite the decision in Trevisan & Anor v FC of T much care must be taken when considering using the employer sponsor as a trustee of a unit trust. If the unit trust is to be used as an investment vehicle and for no other purposes then the trustee may be individuals.

Taxation of self managed superannuation funds ("SMFS")

Income tax of SMFs-

The income of SMFs are taxed at 15% on every $1 of income. It should be noted, however, that the income of an SMF is only taxed at 15% if it is a complying superannuation fund. If the SMF breaches any provision in the Superannuation Industry (‘Supervision,) Act 1993 & Superannuation Industry (Supervision) Regulations 1994 (C‘th,), all the assets of the SMF and the income for the years that it is non-complying will be taxed at the top marginal rate of 47% plus 1.5% Medicare levy.

As well as that, if a superannuation fund enters into a transaction that is not at arm's length, and the superannuation receives more income than it otherwise would if the transaction was entered into at arm's length, that income will be taxed at 47% plus 1.5% Medicare levy.

Taxation of contributions

Un-deducted contributions are not taxed. Therefore, where members of an SMF make an un-deducted contribution into the SMF, it goes in "tax-free".

However, if an employer makes a contribution into a SMF, and intend on claiming a tax deduction on those contributions, such deduction can be claimed up to the age based limit of the member in respect of whom the contribution is made.

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The age based limit for the 2000/01 financial year is as follows:

Tax Deduction Limits

Age	2000/2001
Under 35	$11,388
35to50	$31,631
Over 50	$78,445

These limits will be indexed by wage rises in future years.

Contributions that are subject to a tax deduction are taxed at 15%.
For Self employed persons, a full tax deduction can be claimed on the first $3,000 of SMF contributions and will then get a 75% tax deduction on any contributions exceeding $3,000 but below the relevant member's age based limit. Again, any such deductible contributions will be subject to 15% tax.

Surcharge Tax

There is also a contributions surcharge tax. A surcharge of up to 15% applies to tax deductible superannuation contributions ("TDSCs") made by employers and self-employed persons to superannuation hinds in respect of members with (adjusted) earnings of more than $98,955 for the 2000/2001 fiscal year (as indexed).

The surcharge is phased-in for those with taxable income and TDSCs between $81,493 and $98,955, with a 1% surcharge levied for each $1,165 that the member's taxable income and TDSCs exceeds $81,493. It is capped at a maximum of 15% rate once the member's taxable income and TDSCs reaches $98,955. Accordingly, the maximum contributions tax and surcharge payable by a superannuation fund for persons with more than $98,955 taxable income and TDSCs is 30%. These thresholds will be indexed in each subsequent year. In many funds, the overall tax rate may be lower due to franking credits and deductible expenses.

Trustees must report detailed information to the ATO on each member (including tax file numbers and TDSC5) prior to October 31 for the prior fiscal year unless they elect to self-assess their surcharge liability. Note, that SMFs that elect to self-assess have until March 3 1 in relation to the prior fiscal year to finalise their surcharge reporting requirements. Trustees should be mindful of their obligations and liabilities under this legislation and ensure that their fund has sufficient cash flow to make any surcharge payment.

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Capital Gains Tax for SMF's

For any CGT asset which is the subject of a CGT event (such as a disposal or sale) that occurred after 21 September 1999 and for which no indexation shall be applied to its cost base, the gain will only be assessed at the rate of 10% where the CGT asset has been held for at least 12 months. The gain will be taxed at 10% because, as discussed above, the CUT discount is 33% and the tax rate of a complying superannuation fund is 15%.

Other issues

The above tax rates for SMFs therefore make these vehicles very attractive from a taxation perspective.

However, there are various other issues that must be considered. These include the fact that the scope for investment and use of the investments are somewhat restricted by the very proscriptive and complex investment rules contained in the Superannuation Industry (Supervision) Act 1993 (C'th). Further, there are dangers that a minor slip up in the administration of the SMF could render it non-complying and therefore attract the highest marginal tax rate of 47% plus the 1.5% Medicare levy. There is also the matter that the money in the SMF is locked in until the relevant member reaches an appropriate age where the moneys become unpreserved and benefits can be taken from the SMF. However, if the relevant investor is reaching the age of 55 years, when a retirement benefits can be taken, or 65 years when old age benefits can be taken regardless of the fact that you are still in gainful employment, such a vehicle would be of particular attraction.

Even for the younger investor, an investor could establish a SMF and own investment properties as tenants-in-common with their SMF. However, it should be noted that specific advice should be sought on the investment rules. Under the investment rules for SMFs, there is more flexibility where the investment is commercial real estate or any other form of real estate that is used to carry on a person's business. In the case of an investor owning an asset as tenants-in-common with their SMF, it must be noted that the investor will not be able to live in the property or otherwise use that property for themselves or any relatives or other associates.

Other matters that must be considered when owning an asset as tenants-in-common with you SMF, is that the transaction must be at arm's length and consistent with the financial strategy of the SMF. Most importantly, the property owned as tenants-in-common, with your SMF cannot be used as security. Further, the co-ownership of the property must not constitute providing financial assistance to the relevant investor-member.

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The principal place of residence

The desire of many Australian to own their own home coupled with the non-deductible nature of a home mortgage and our marginal tax rate system has had the effect of limiting a taxpayers after-tax cash surplus and therefore ability to purchase a family home. As prices continue to skyrocket and demand exceeds supply housing becomes out of reach for many families. Young couples and home buyers in general have to consider what options are available to them to assist financially in acquiring either their first property or upgrading to a better property.

An alternative available, is the repayment of a home mortgage with pre-tax dollars as was the case of Doctor Redman in FC of T v Janmor Nominees Pty Ltd (1987) 87 ATC 4813 ("Janmor Nominees") which has been reproduced below. There are many advantages and disadvantages of purchasing the family home in a trust, and it is the opinion of the author that the final family residence should not be purchased in such a structure. There is however, unlimited advantages in purchasing the first home, unit or duplex in a trust and if structured correctly, the ability to refinance and have a tax-deductible loan on the family residence not purchased in a trust may be achieved.

In Janmor Nominees the taxpayer company was the trustee of a doctor's family trust. After obtaining mortgage finance the trust purchased a residential property which it then leased to the doctor at a commercial rent. The residence was occupied by the doctor and his family. In its 1980 tax return the trust included the rent from the property in its assessable income and claimed a deduction for its expenditure on mortgage interest, borrowing expenses, insurance, rates and part of the cost of repairs. The outgoings on the property exceeded the income of the trust for the year so that a nett loss was claimed. The Commissioner of Taxation disallowed the loss and the taxpayer objected. The Commissioner then issued an amended assessment allowing the mortgage interest deduction only to the extent of rent received from the leasing of the property. Apart from the expenditure on repairs, which was only partially allowed, the remaining expenditure was allowed in full. The taxpayer objected to the amended assessment and, on its objection being disallowed, sought a reference to a Board of Review.

The Board upheld the taxpayer's claim to deduct the mortgage interest in full, but disallowed the claim for repairs in full. The Commissioner appealed to the Victorian Supreme Court which upheld the Board's decision. The Commissioner then appealed to the Federal Court. The Commissioner contended that the rent received by the taxpayer was not assessable income, but that even it if was assessable income the interest payments were not made in gaining or producing the assessable income, or if they were, they were payments of a private or domestic nature. The Commissioner also argued that sec. 260 applied to render the leasing agreement void. The Full Federal Court found that even though the transaction was familial in nature and motivated by familial considerations it was not conclusive and that he doctor motivated by i desire to purchase an asset arid provide same for his family. The court ruled in favour of the taxpayer and dismissed Commissioners appeal.

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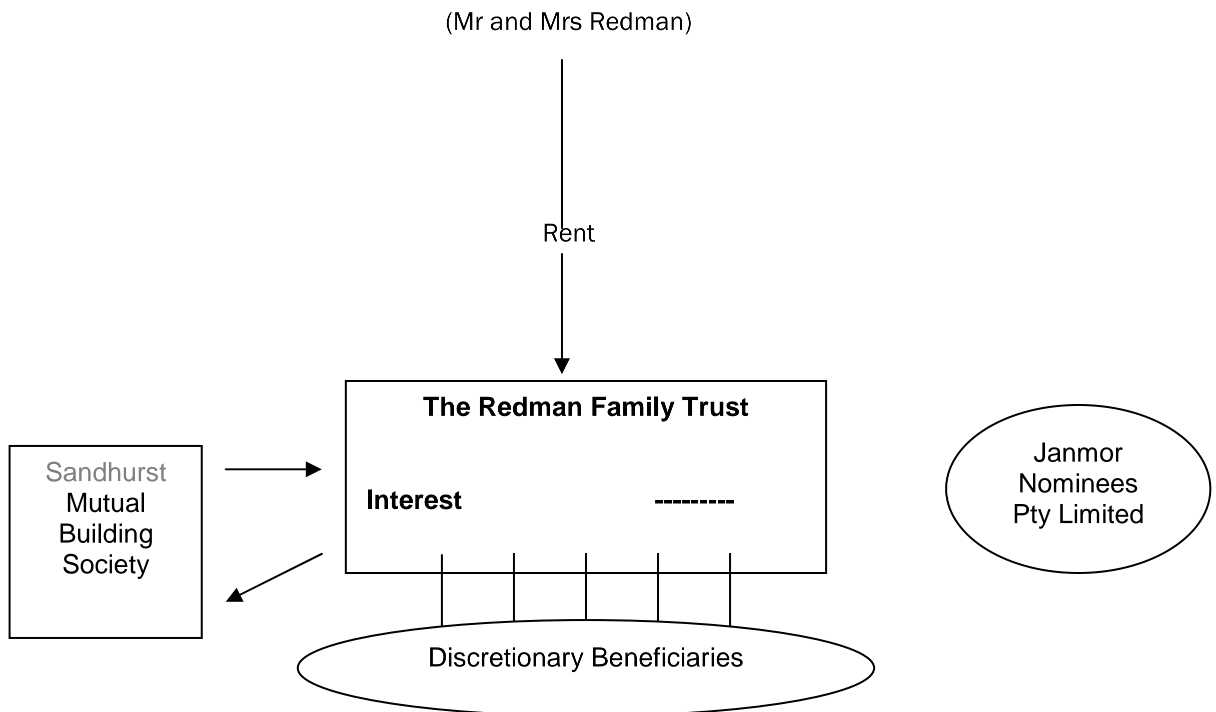
The case hits heat diagrammatically reproduced at diagram.

Diagram 9



Although the taxpayer was successful in Janitor Nominees and similar victories have defended in the courts as late as Madigan v FC of T (1996) 96 ATC 4640. There are many arrangements that are not acceptable to the Australian Taxation Office and have also received judicial disapproval. Income Tax Ruling IT 2167 discusses various non-economic rental arrangements including:

1. Arms length letting of an identified part of a residence, eg, a bedroom, with access to general living areas of the residence.

2. Letting of property to relatives.

3. Payment to family members of an amount for board and lodging

4. Occupancy of a part of a residence on the basis of occupants sharing household costs such as food, electricity, heating, etc.

5. Letting of a holiday home or potential retirement home for part only of a year.

6. Letting of a residence during a transfer in place of employment

7. Purchase of a residence by a family trust and the subsequent leasing of it to family beneficiaries in the trust.

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There have also been a number of cases on the deductibility of mortgage payments. In FC of T v Groser (1982) 82 ATC 4478 the taxpayer charged his invalid brother $2.00 per week to occupy a dwelling owned by himself. In 1977 the rent received amounted to $104.00 and the taxpayer claimed $544.00 in outgoing (rates, mortgage interest, insurance, etc) The Commissioner assessed the taxpayer on the basis that the payments were not assessable and the expenses not deductible. Jenkins J found that the payments were:

"a contribution to the funds out of which the taxpayer proposed to defray the expenses of ensuring proper care of his brother. The arrangement had nothing to do with transactions of a kind, which result in the receipt of income as understood in ordinary usage."

In FC of T v Kowal (1984) 84 ATC 4001 and more recently Madigan v FC of T (1996) the Courts held that the outgoings had to be apportioned to the extent that they did not exceed the amount of rent received. In Kowai's case the premises were let out at $10.00 per week when a commercial rent would have been $50.00 per week and in Madigan's case rent charges was $150.00 per week when a commercial rent would have been $600.00 per week. It is therefore crucial, to any such arrangement that a commercial amount of rent is charged.

Another form of apportionment is on a time basis, where the rent charged is commercial however is only for a portion of the year. In case P116(1982) 82 ATC 590 a property was let for 16 days during the year of income, occupied by the owners for 107 and vacant for the balance of the year. The Taxation Board of Review confirmed the Commissioners assessments in apportioning the losses and outgoings attributable to the property on a time basis and allowed a deduction for the proportion that the property was let, ie 4.4%.

Assuming that an arrangement was entered into along the lines of Janmor's case the following advantages & disadvantages can be expected:

Advantages:

1. Ability to claim as a tax deduction interest on mortgage.
2. Asset protected by virtue of being owned by a discretionary trust.
3. Suitable structure for rental property.
4. If correct trust structure used (hybrid trust) refinancing principle may apply.
5. Due to high marginal tax rates deductibility of interest on mortgage may enable for the purchase of a larger residence.

Disadvantages:

1. Loss of principle residence exemption
2. Possible land tax implication.
3. If rent exceeds deductible expenses then assessable profit being derived from non-assessable amounts.
4. If standard discretionary trust used then losses trapped in trust.

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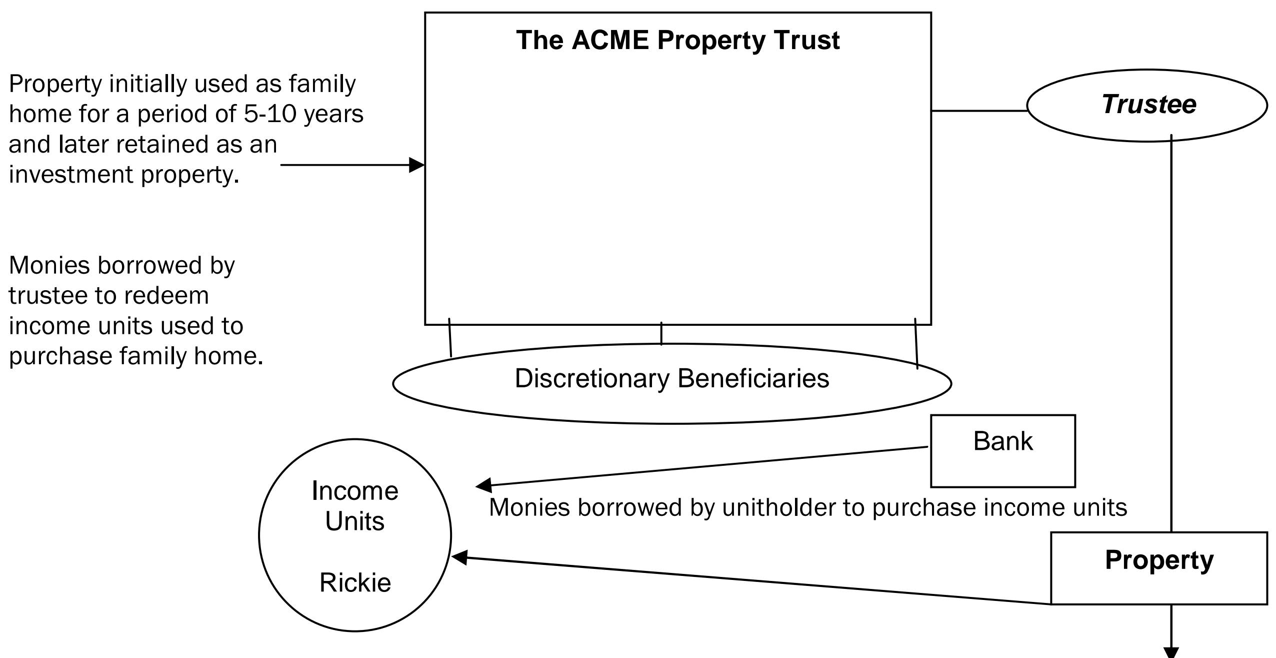
types of trust

As stated earlier it may not be advisable to purchase the final residence in a trust structure as eventually rent will exceed outgoings and this will have the affect of turning non-assessable amounts (money used to pay rent) into assessable income (assessable distributions from the trust). On the other hand a transitional or first home if purchased in a trust and used for 5-10 years as the principal residence provides many benefits. Not only would the mortgage be deductible but if a hybrid discretionary trust was used then the refinancing principle may be used to claim a tax deduction on a mortgage where the funds were used to purchase a family home in the taxpayers name.

Rickie and Chris purchase a two bedroom unit in a hybrid discretionary trust. Rickie borrows funds to purchase income units as her income exceeds Chris' and she is on higher marginal tax rates. Upon repayment of the loan, Rickie and Chris decide to retain the property as an investment and purchase a family home in Rickie's name (for asset protection). If the trustee borrows the money to redeem Rickie's income units, the interest on the loan is deductible regardless of Rickie's use of the funds as the trustee has reduced its liability to pay a beneficiary a share of nett income of the trust estate.

The above has been diagrammatically reproduced in diagram 10

Diagram 10



Note: There exists the potential to acquire a residence in a hybrid discretionary trust whereby a lease would be drawn between the trustees and the wife for an extended period. The taxation consequences would mean that interest on the loan would be deductible and the gain derived upon the sale of the property would be exempt from capital gains.

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The Discretionary Trust method of acquiring the family home

It is possible to negatively gear the family home by imposing a family trust between the financier and the residents of the house. For example, assume;

1. a trust is established with a husband and wife as beneficiaries;
2. the trust borrows $600,000.00 from a bank;
3. the trust purchases a house for $600,000.00;
4. the trust grants a long-term lease of the house to the husband and wife in consideration for market rental.

The following taxation consequences will arise:

1. as the trust has borrowed funds to purchase an income-producing asset, namely the house, the interest payable to the bank would be an allowable deduction from the income of the trust. The trust will have achieved negative gearing of the house if the interest paid exceeds the rent received.

2. the husband and wife's lease of the house will, for the purposes of the capital gains legislation, constitute ownership of a dwelling (section 1 60ZZQ(s)). Provided the house is used as their sole or principal residence the sale by the husband and wife of their leasehold interest will be exempt from the capital gains legislation under section 160ZZQ. The leasehold interest will be sold for its market value. A the lease is long-term, say 20 years with five 10 year options, its market value should be substantial.

3. the reversionary interest in the house owned by the trustee (i.e., the trustee owns the house subject to the lease) could also be sold to the purchase of subject to a lease, the sale of these is reversionary interest could result in a capital loss to the trustee. It should not result in a capital gain.

In summary, a deduction has been obtained for the interest expense and nett capital gain has not arisen upon the sale of the two assets. In order for the interest expense to be an allowable deduction, a market rental must be paid by the husband and wife to the trust (refer FCT v Janmor Nominees Pty Ltd 87 ATC 4813).

Capital Gains Tax

In it's 20 August budget in 1998, the Federal Government made certain changes to the timing of the disposal of a dwelling (previously the deceased taxpayers principal place of residence) by the beneficiary of a deceased estate whereby the dwelling was not used as the principal residence of the beneficiary. A capital gain shall not be deemed to have accrued or a capital loss incurred where the dwelling is disposed of within 2 years following the date of death of the deceased.

Much care needs to be taken in this area as there is a great deal of confusion as to when a capital gain does accrue to a beneficiary and therefore the following scenarios will be addressed:

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A dwelling is acquired by a taxpayer, being a natural person who acquired the dwelling as a beneficiary in the estate of a deceased person is used as their principal place of residence and was the principal place of residence of the deceased.

Where the dwelling became the principal place of residence of the beneficiary but was never used by the deceased as his/her principal residence.

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Where the dwelling was the principal place of residence and subsequently used as a rental property and disposed of later than two years.

Where the dwelling was the principal place of residence of the deceased and sold by the beneficiary with 2 years following the death of the taxpayer.

Where a surviving spouse temporarily vacates the premises and subsequently disposes of same.

In the first example above sections 16OZZQ (1.3) and (13A) apply where the following are satisfied and I refer paragraph (d) of subsection 1 6OZZQ (13):

"if the dwelling was, throughout the period from the death of the deceased person during which the dwelling was owned by the legal personal representative of the deceased person, the sole or principal residence of any one or more of the following:"

1. the person who was, immediately be/ore the death of the deceased person, the spouse of the deceased person;

2. a person who, under the Will of the deceased person, had a right to occupy the dwelling;

a capital gain shall not be deemed to have accrued to the taxpayer, and a capital loss shall not be deemed to have been incurred by the taxpayer, as the case requires, in respect of the disposal of the dwelling."

If the qualifications of either subsection (13) or (1 3A) are satisfied then there is no capital gains tax at the time of disposal regardless of whether the property is sold within 2 years or twenty years.

Furthermore, if the surviving spouse as in (d) (I) above elects under subsection I 6OZZQ (11 A) the property may be rented for up to six years and still no capital gains tax applies, which may effectively extend the no capital gains tax window to 6 years instead of 2 years however, an election under the said subsection needs to be made on or before the date of lodgment of the return of income of the deceased taxpayer's estate for the year of income in which the taxpayer died.

A partial exemption exists for beneficiaries who use the dwelling as their principal place of residence and it was never used by the deceased as a principal place of residence. The exemption will be pro-rated on the basis of time and the extent the dwelling was used as a principal residence of the beneficiary, over the time the dwelling was owned by the deceased and the beneficiary. If the beneficiary makes the dwelling his/her principal residence and I refer Taxation Determination TD51 and comments of William J in Koitaki Para Rubber Estates Limited v FC of T (1941)64 CLR 241, at 249:

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"The place of residence of an individual is determined, not be the situation of some business or property he is carrying on or owns, but by reference to where he eats and sleeps and has his settled or usual abode."

Then once again an election under subsection 1 6OZZQ (11 A) may extend the capital gains tax free period to 6 years.

Where the dwelling was the principal residence of the taxpayer and the beneficiary uses the property for rental purposes and it is sold later than two years following the death, the cost base shall be calculated with reference to the market value of the asset at the date of death. This is in contravention to the current subsection 160X (5) (b) (i) if the asset was acquired by the deceased as his/her principal residence prior to death.

The final scenario involves the new initiatives introduced in the August budget extending the qualifying period regarding the disposal of a dwelling which was previously the principal residence from 12 months to 2 years. The previous subsections were 1 6OZZQ(14) and (15) and I would suggest that (14A) and (iSA) will be introduced. This is where the beneficiary does not use the property as his/her principal residence as in subsection (13).

Note: *Subsection 1 6OZZQ(2l) outlines the pro rata exemption where a dwelling has been used to gain or produce assessable income and must be taken into consideration regarding any of the above subsections under section L6OZZQ. I would advise careful attention when advising on the capital gains tax implications of the disposal by a beneficiary of a dwelling, which was previously the principal residence of the deceased. Careful planning and I refer subsection 1 6OZZQ(11) and favourable market valuations may both reduce and delay any incidence of capital gains tax for a client.*

fundamental learning

This module can be very complex and one that should be discussed with your accountant or financial advisor depending on your personal financial position.

Below write out what you have learnt from this module.

Write down why you should use a trust to protect your assets

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Write down what type of trust is right for you and why.

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