TOP 11 Family trust MISTAKES not to make

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Financial Education for All Australians

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We look forward to meeting you soon.

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Introduction

A 'discretionary trust' (more commonly known as a 'family trust') can be a very useful and powerful tool in the pursuit of long term wealth generation and maintenance. The purpose of this guide is to briefly explain what family trusts are and then to focus on some of the, potentially very costly mistakes that are sometimes made in this area. This could help you to make the decision on whether a family trust would be the right option in your particular circumstances. Hopefully the information presented here will also be valuable in terms of helping you to steer clear of some of the pitfalls associated with family trusts.

Trusts can be a fairly complex area and it is highly recommended that you get the best possible expert help before fully committing yourself. The need for financial advice does not cease once the trust is up and running. You will at all times have to ensure that your trust remains compliant in the areas of governance, taxation and income distribution. Getting knowledgeable and competent advisors on board should, therefore, not simply be seen as a 'nice to have' but as a vital part of successfully using a family trust to build and safeguard wealth.

Family Trust: The Basics

Under Australian law a family trust refers to a discretionary trust that was created to hold the assets belonging to a family or to conduct a family business. Such trusts are commonly set up in order to protect assets or to distribute investment income.

Family trusts generally have the following characteristics:

- Established by a family member in order to benefit the 'family group'
- Can be the subject of a family trust election (see below) which provides it with certain tax advantages, provided that the trust passes the family control test and makes distributions of trust income only to beneficiaries of the trust who are within the 'family group'
- Can assist in protecting the family group's assets from the liabilities of one or more of the family members (for instance, in the event of a family member's bankruptcy or insolvency)
- Provides a mechanism to pass family assets to future generations
- Can provide a means of accessing favourable taxation treatment by ensuring all family members use their "tax-free thresholds"

The following elements have to be put in place in order to set up a family trust:

a) A trust deed: The trust deed is used to clearly set out the terms and conditions under which the trust is established and maintained. A trust is formally established when the trust settlor (see below) and the trustee(s) signs a trust deed and an initial amount is given by the settlor to get the trust up-and-running.

b) A settlor: The function of the settlor is to assist in getting the trust of the ground by 'giving' an initial asset (technically known as 'settling an asset on the trust'). This is often simply a token amount, although more substantial assets may also be transferred at this stage. After the settlor executes the trust deed in this way he or she will generally have no further involvement with the trust. This role is sometimes fulfilled by a lawyer, accountant or financial advisor but a family member or friend could also be asked to act as settlor.

c) The trustee(s): The ultimate responsibility for managing the trust and its assets rests with the trustee(s). In the case of typical family trusts this role is often fulfilled by 'mum and dad' (or by a company of which they are shareholders and directors) with the children and other dependents listed as beneficiaries.

d) 'Family Trust Election': This refers to the choice made by a trustee to nominate a particular individual (known as the 'test individual') around whom a family group is formed. This is a fairly complicated area and getting competent advice is strongly advised. Once a FTE has been made significant restriction as to who can be beneficiaries of the trust come into play. In general, the 'family group' could include the following people for taxation purposes:

- The test individual and his or her spouse
- Any child, nephew or niece of the test individual or their spouse, and any lineal descendent of these individuals
- The spouse of anyone mentioned above

The list above should make it clear that great care will have to be exercised in nominating the test individual as a wrong choice could lead to someone being 'left out of the circle'. This could have pretty dire consequences. According to ATO: "*A consequence of making a family trust election is that any distributions (broadly defined) outside the family group of the family trust by the trust will be taxed at the top marginal rate applying to individuals plus the Medicare levy.*"

One of the most appealing aspects of a family trust is that the trustee(s) can distribute income earned by the trust in any way they see fit as long as distributions are made to those who qualify as beneficiaries. They can, for example, vary proportions over subsequent years in line with the needs of the recipients.

A trust is not required to pay income tax on income that is distributed to beneficiaries

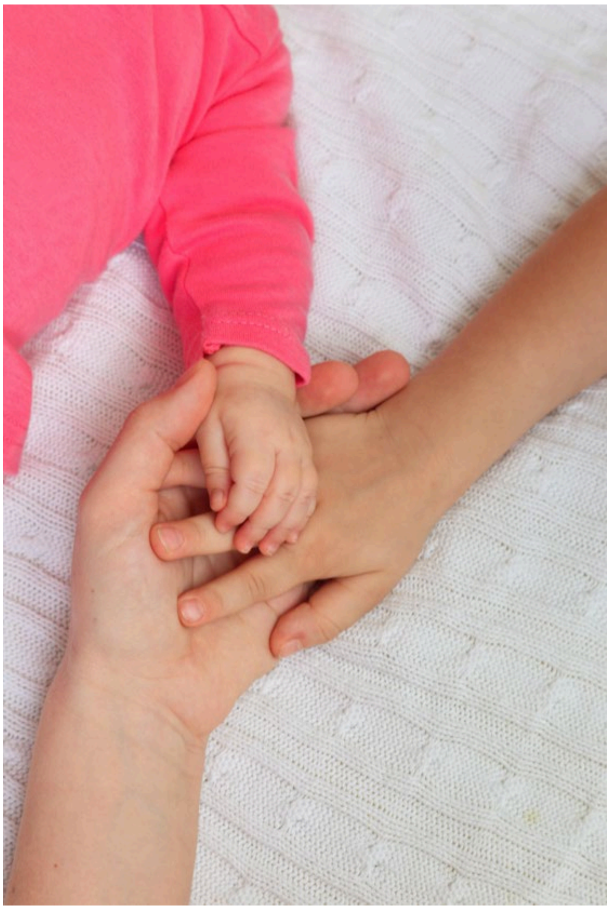
(undistributed income will, however, be taxed). This means that the trustees are free to distribute income to as many beneficiaries as possible and in ways that will help them to take the best possible advantage of tax free thresholds. Once beneficiaries receive a benefit from a trust this must be included in their income declarations.

It should be remembered that distributions received from a trust are not a special form of income, but instead forms part of a beneficiary's assessable income. If the beneficiary receives income from other sources in addition to distributions from the trust, all of the income will be taxed together.

Undistributed income left in the trust is taxed at the top marginal tax rate giving a strong incentive to family trusts to fully distribute the trust's income before the end of each financial year.

The trustee should also take care in relation to which beneficiaries are chosen to receive distributions, as penalty tax rates can apply to distributions made to minors.

With the preliminary discussions out of the way it is now time to turn to some of the serious mistakes that people often make when they place their assets in family trusts. The hope is, once again, that the listing of these mistakes well help you to avoid them (and beyond that to determine whether a trust is the best option in your current circumstances).



Mistake #1 – Forgetting that trusts have 'Expiry Dates'

If you are aiming for long-term intergenerational wealth creation and maintenance you will need to think long and hard before committing your assets to a family trust. This is because legislation does not allow for trusts to be set up to exist indefinitely. All states and territories have 'Rules against Perpetuity' governing trusts and these are strictly enforced. This means that you generally shouldn't expect any trust that you set up to last beyond its 80th year.

When the anti-perpetuity rules kick in trustees will be forced to transfer assets out of the trust. This will trigger a Capital Gains Tax event. You may not see this as much of a problem since you will not be around to witness this happening but your children and grandchildren could be hit with a very large and unexpected tax bill! If, therefore, you are taking a very long view as far as your wealth building strategy is concerned you should probably also be looking at some other options besides the setting up of a trust.

Mistake #2 – Placing too much emphasis on asset protection

It is very common for people who begin to 'get ahead' financially to start looking around for ways in which they can protect their wealth and assets. While this is a completely understandable sentiment it is important to understand that an overly cautious approach can sometimes come with a heavy price tag attached in the sense that the price you pay for protection may be more significant than the perceived benefit you are gaining.

It is, of course, true that there is a possibility that some catastrophe could threaten your asset base and that a trust will offer some protection. You need to consider, however, what the probability is of this occurring and whether a trust is necessarily the best way to protect yourself.

In general the kind of liability that could threaten your financial position would most likely arise from your professional activities or from an event for which you are held responsible (e.g. your dog seriously injures someone). Of course there is no guarantee that such an event will or will not happen and we have to make a call on the probability of such things happening. Something that we are generally not very adept at doing. We need to acknowledge, however, that for most people who are not in high-risk occupations the probabilities of a first-order catastrophe hurting them financially is probably moderate to low.

Even if catastrophe occurs some protective systems will in most cases have to fail spectacularly for a liability to land on your doorstep:

- If you are in a high risk occupation, your Professional Indemnity insurance needs to fail
- If it is an adverse event (e.g. the dog incident mentioned above) your Liability Policy needs to fail

Even if one of the 'fails' mentioned above does occur and you are landed with the liability there may still be some options (e.g. a negotiated settlement) that could allow you to avoid bankruptcy as the worst possible outcome.

It should be clear, in light of the above, that embarking on complicated structural adjustments (which may include making use of trusts) in order to defend yourself against low probability events may not be the best use of your resources and assets. So if asset protection is the only reason why you are considering a trust you may want to get a bit more professional advice before fully committing yourself.

Mistake #3 – Forgetting about 'Personal Services Income' (PSI)

Income placed under the control of a family trust will potentially fall into one of two categories namely investment income or work related income. Under current tax law work related income will normally be judged to be Personal Services Income which means that it will be subject to anti-tax avoidance measures. Tax will be payable on that income as if you were an employee. This means that you will not be able to channel work income to someone else as a means of reducing your tax liability.

One of the basic steps to find out whether your income will be classed as Personal Services Income is to head to the following webpage hosted by ATO:

https://www.ato.gov.au/Business/Personal-services-income/ It is also strongly recommended that you consult an accountant on this issue before spending money and effort to set up the trust.

Mistakes #4 – Not factoring in land tax

A cost associated with owning property that is often missed by inexperienced investors is the fact that some properties may attract a land tax. This tax exists in all states and territories (except currently in the Northern Territory) and it has to be factored into decisions on family trusts as will be made clear below.

The rates and thresholds associated with land tax differ from state to state. For example you can own up to $734,000 of land in NSW before the tax kicks in. In Queensland and Victoria the threshold is $600,000 and $250,000 respectively. These thresholds are impacted very significantly when properties are placed inside a trust. In NSW you will be required to pay Land Tax at 1.6% on total value straight of the bat with no threshold applied (this will translate into $11,844 per year on

$734,000 land value). This could obviously represent a significant dent in your bottom line. There are, once again, differences between the states. In Victoria and Queensland the threshold does not drop to zero but it will still be significantly reduced once a property is placed in a trust (to

$25,000 in Victoria and $350,000 in Queensland).

It could, in light of the above, be that the protection that you think you are gaining by placing assets in a trust could come at a significant cost (i.e. almost $12,000 dollar p.a. in the case of $734,000 land value in NSW). It is, therefore, once again important that you assess the numbers and weigh the pros and cons before fully committing yourself.

Mistake #5 – Not understanding the impact of losses on the trust

Losses, both in terms of revenue and capital, are 'caught' inside a trust and cannot be distributed. This means that they will be reflected in the statements of the trust. Such losses cannot be parcelled out and reflected in the tax statements of individuals associated with the trust.

Losses 'caught' in trusts can therefore not be offset against personal income and gains. This will pose a particular problem for those who rely on the tax benefits associated with negative gearing as they will not be able to claim the tax relief associated with losses on negatively geared properties inside trusts.

Placing negatively geared properties inside a family trust could therefore represent an extremely costly mistake.

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Mistake #6 – Not fully familiarising yourself with the contents of the trust deed

None of us like nasty surprises and there can be few surprises quite as unpleasant as realising that what you thought were carefully worked out financial plans are not quite as watertight as you thought they were.

In the case of family trusts you can avoid this by making absolutely sure that you know exactly what is in the trust deed as this is ultimately the document that governs every aspect of your trust. We strongly recommend that you read the deeds of trusts that you are involved with (or are planning to become involved with) as carefully as possible. While doing so take careful note of things that are perhaps a bit too vague or that you do not fully understand.

This is one area where hoping for the best simply will not cut it. If your reading of the deed leaves you with questions or if you simply do not understand parts of the deed, seek out the help of your advisors.

Mistake #7 – Being unaware of penalty tax rates for underage children

Please do not set up a family trust if you think that you can use your children to give you some tax relief. This is because distributions to minors are taxed at an eye watering rate. Any income above $416 up to $1,307 distributed to a minor will be taxed at 68% (66% plus Medicare), with any amount above $1,307 tax at 45% (45% plus Medicare).

So while it is certainly true that adult children will often benefit greatly from being named as a beneficiary of a family trust the same does not automatically hold true for minors. There are certainly many more tax efficient ways to help secure their financial futures than giving 47% - 68% to the taxman!

Mistake #8 – Not being careful enough with the appointment of trustees

Setting up a trust is a serious and rather expensive undertaking. It is, therefore, important that you do not try to save crumbs in the wrong places. One of the most common false economies that can come

back to haunt investors is the fallout that can often occur due to a failure to appoint a corporate trustee.

It is true that it is cheaper to have an individual as a trustee but that leaves that individual exposed to all sorts of risks associated with the trust. This is a particularly ironic situation given that many trusts are set up with asset protection as a key goal. The

risks associated with being an individual trustee can be effectively mitigated through the appointment of a corporate trustee.

Yes, it will be more expensive but the little bit of extra money that you will be spending will buy you an extra layer of protection and the resultant peace of mind.

Mistake #9 – Not determining whether it is necessary to have an 'appointor'

There are some strange and novel functions associated with a family trust and the 'appointor' certainly falls within this category. While the appointing of an appointor is not necessarily a hard and fast legal requirement many trust deeds will, for a variety of reasons, contain provisions that will allow for the creation of such a position. You need to have a look at your trust deeds to ascertain whether this is true in your case. This is because the role of appointor carries with it a significant level of power. Chief among these is the power to sack trustees! You will, therefore, want to know whether this role exists in the trust deed of any existing or to-be-created trusts that you are involved with.

Even if you do not have the role of appointor specified in your trust deeds you will certainly do well to seek professional help to determine whether this is something that should be included in your trust deed. Some questions that such an advisor can help you to work through are:

- What are some of the reasons behind nominating an appointor?
- Are there circumstances that would make nominating an appointor in this case a good idea?
- Who will it be?
- Might it be necessary to have more than one?

Mistake #10 – Using form documents

If there is one area where 'One size fits all' most definitely does not apply it is family trusts. Families and their financial needs differ like night and day. Yet in spite of this many people believe that setting up a trust is as simple as filling in forms found on the internet or in legal software packages. This is, needless to say, a highly risky strategy (or rather lack of strategy!)

Not only can you not be totally sure that such forms really fulfil all the exacting legal requirements associated with trusts, they are also necessarily designed to serve the 'average' investor. Therefore, sadly they often deliver only average results. Here it is worth repeating the principle that 'saving' money can sometimes be a sure fire way to wasting it.

Getting advice and professional help will certainly cost you something but messing up the setting up of a family trust could very well cost you much more.

Mistake #11 – Neglecting to update your trust

A trust is not something that you can simply set up and then forget about. Circumstances change and trust deeds will therefore have to change to keep up instead of being regarded as something written in stone.

We strongly recommend that you review your trust documents to ensure that they still meet your needs. Some of the following events could trigger a review:

- Births or deaths
- Marriage or divorce
- Job changes
- Retirement
- Tax law changes

Changes such as these represent a good opportunity to take stock.

Conclusion

It should be clear from the above that setting up a family trust may not be for every single investor out there. However it can be a very wise step under some circumstances. We would, in light of this strongly recommend that you take the time to weigh up all the pros and cons and get professional legal, tax and financial planning advisers involved.

We trust that this guide was useful in helping you to think through some of the issues associated with trusts and that it also set you thinking about some wider financial planning issues.

It would be impossible, however, to present a complete guide to all your financial planning needs in a document as brief as this. We urge you to continue your explorations by making use of some of the other resources and eBooks from the Wealth Adviser stable.

Readers Notes

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