

# The Discretionary Trust - Efficiency in Trade Investments

## 1. GENERAL OUTLINE





We have had many recent queries concerning proposed changes to the legislation affecting the manner in which trusts are taxed. This article aims to address the present market concern as to the ongoing viability of discretionary trusts as useful tools for both trade and investment.

### Your trust is safe

Discretionary trusts can be confusing and complex, especially if you are using them for the first time. The new *trust loss measures* affecting discretionary and family trusts would certainly seem to make trusts even more complicated to understand. For many, the media hype surrounding the trust loss measures created an unwarranted fear of the beneficial uses of discretionary trusts. Much was made of the fact that the government was "clamping down" on the unbridled use of family trusts, for instance, as schemes to minimise tax on income distribution.

Unfortunately, the interpretation given to the new amendments has been far from accurate. Properly structured and administered discretionary and family trusts still remain a desirable alternative as an investment structure. In certain circumstances for example, discretionary trusts will fully maintain tax shelters on distributions at a beneficiary level. Moreover, a discretionary trust can provide for a great deal of flexibility in terms of amounts and/or character of the distributions of income.

To assist your understanding of the trust loss measures, we have prepared the following short summary of its impact on discretionary trusts. This includes:

-  An overview of the trust loss measures – their potential effect on your trust structure;
-  What makes a trust a family trust – and how you can benefit from making a "family election";
-  The new tests for discretionary/family trusts – how to comply and take advantage of tax minimisation; and
-  A comparison of different investment structures – and why a discretionary trust "out-performs" other structures in certain situations.

If, after reading our overview on the new trust loss measures and the benefits of discretionary trusts, you are uncertain as to whether your trust structure complies with the law, you should immediately seek professional advice, as any further transactions may have significant tax and other consequences.

## 2. ABOUT THE TRUST LOSS AMENDMENTS- Overview and policy objective

The purpose of the trust loss measures is to restrict the recoupment of prior year and current year losses and debt deductions of trusts in order to prevent the transfer of the tax benefit of those losses or deductions. The measures achieve this aim by examining whether there has been a change in majority underlying beneficial ownership or control of a trust or whether certain income injection schemes have been entered into in order to take advantage of a trust's losses. The new measures apply to two broad categories of trusts referred to in the measures as fixed trusts and non-fixed trusts. Non-fixed trusts include discretionary trusts.

The perceived mischief that the government is attempting to curb occurs when the tax benefit of losses is transferred. This occurs when a person who did not bear the economic loss at the time it was incurred by the trust obtains a benefit from the trust being able to deduct the loss. The new provisions generally will not apply to **family trusts** that make distributions **only** to members of a family group.

### 3. WHEN IS A TRUST A FAMILY TRUST?

A trust becomes a family trust by making a *family trust election* specifying a particular individual whose family is to benefit from the trust. Associated entities that are not wholly owned by the family of a specified individual may be able to become a member of the family group by making an *interposed entity election*

If a family trust, or a trust, company or partnership that makes an interposed entity election has made a distribution of income or capital to persons outside the defined family group, or if such persons become presently entitled to the income or capital, then *family trust distribution tax* is payable.

The tests to be satisfied before losses are deductible will vary depending on the type of trust. Each type of trust will have to satisfy certain tests relating to ownership or control of the trust in order to be able to deduct current and prior year losses and debt deductions. There are tracing rules to monitor ownership of trust interests where certain entities are interposed between the loss trust and the underlying beneficiaries. **These tests will generally not apply to family trusts. Family trusts that distribute only to members of the family group, and which make an election for the purpose, will generally not be affected by the amendments.** However, where a family trust distributes income or capital to persons outside the family group, a special tax, the family trust distribution tax, will be payable. This will be levied at the top marginal rate plus Medicare levy (48.5%), or at the rate of 100% where a non-resident entity becomes liable to family trust distribution tax and the Commissioner cannot recover the tax because of territorial limitations.

#### What is the definition of a "family trust"?

A family trust is defined as a trust which distributes income and capital to beneficiaries who comprise a natural person and members of their family such as spouse, children, grandparents, brothers, sisters, etc, family entities, or distributes income to charities listed under sec 78. For the normal discretionary trust to be classified as a family trust it will be necessary to make an election that the trust will only distribute to family members or sec 78 charities. Additionally, to qualify for conversion to a family trust, family members must be in full control of the trust during the transitional period 9 May 1995 to 1 July 1997.

### 4. THE NEW TESTS – their effect on your trust

The tests will apply such that, if certain events occur, a trust:

1. may be prevented from deducting its tax losses of earlier income years; and
2. may have to work out in a special way its net income and tax loss; and
3. may be prevented from deducting certain amounts in respect of debts (eg. bad debts) incurred in the income year or earlier income years.

For non-fixed trusts, the consequences described above will follow if there is not continuity of majority beneficial ownership of the trust (50% stake test) or if control of the trust changes. These tests do not apply to excepted trusts, including family trusts.

#### Types of tests

Trust losses will be deductible providing the following tests are satisfied:

##### Type of trust

Fixed trusts

##### Tests

Continuity of beneficial ownership;  
Income injection test

<b>Discretionary trusts</b>	<b>Continuity of beneficial ownership; Continuity of control test; Income injection test.</b>
<b>Family trusts</b>	<b>Family control test; Income injection test.</b>
Widely held listed public unit trusts	Continuity of beneficial ownership; Income injection test;
	or
	Same business test; Income injection test

### **What is the income injection test?**

The proposed legislation will provide that an injection of funds by an outsider into a trust will constitute a benefit to a trust. In calculating the injection test, income as well as capital will be treated as a benefit. Family members will be considered "outsiders" under the legislation unless they are the trustee or a beneficiary with a fixed entitlement.

If a trust is involved in an income injection scheme to take advantage of deductions it may be prevented from making full use of them under the income injection test. Under these schemes, income is injected into trusts with losses or other deductions so that no tax is payable on the income.

In general terms, the outsider must provide a benefit to the trust and a return benefit must be given to the outsider.

### **What is the control test?**

Family trusts and discretionary trusts will be required to satisfy the continuity of control test in order to deduct losses. This will require that the same person hold at least 50% of the voting control of the trust.

### **Example**

Andkat Pty Ltd is trustee of the Traffer Family Discretionary Trust. The trustee has decided to sign the election under the proposed tax loss legislation to convert to a family trust. Andrew is the controlling director of the corporate trustee, and is the Principal/Appointor under the trust deed and has the power to remove or appoint a new trustee. Andrew would be considered to be the controller of the trust. The trust made a loss of \$1000 for the year ended 30 June 1997. In order for the loss to be deductible against assessable income in the 1998 year, Andrew would need to be the controller of the trust for the 1998 year, and the income injection test would need to be satisfied.

### **What is the continuity of beneficial ownership test?**

This test must be satisfied by fixed, **discretionary** and public listed trusts. It requires that at least 50% of the underlying beneficial interests or, in the case whereby a meeting can change the entitlements, 50% of the voting rights in the income and corpus of the trust must be held by the same persons in the loss year as in the year in which the deduction is claimed. In order for a discretionary trust to satisfy the continuity of beneficial ownership test, the trust will need to maintain records to substantiate the pattern of distributions to beneficiaries. Beneficiaries must receive on average 50% of income and capital over the preceding two years.

## What is the Family control test

For a trust or other entity to make a family trust election or an interposed entity election, the family must actually control the trust or entity in the initial year for which the election is to be effective. Proposed sec 272-87 is being amended to enable more than one legal or financial adviser to be part of the controlling group, and to enable the family group to consist of the individual specified in the family trust election, one or more members of his or her family, the trustees of one or more trusts in which the individual is also specified, or a combination of any of those persons.

## 5. FAMILY TRUSTS – no need to fear

As set out above, family trusts are subject to concessional treatment and most of the trust loss provisions do not apply to them. Changes in ownership or control of a family trust do not have the consequences explained above provided the trust is a family trust at all the relevant times. However, the rules dealing with income injection schemes do apply to family trusts where persons outside the family group inject income.

### How will the proposed trust loss carry-forward measures impact upon the utility of trusts?

The income injection test appears to be directed at the more blatant forms of "trafficking" in trust losses. **It should not affect the utility of either unit trusts or discretionary trusts in their regular application.**

It is expected that the majority of discretionary trusts will fall, or be brought, within the category of "excepted" family trusts, in which case they will be subject only to the income injection test. In order to qualify as an excepted family trust, it will essentially be necessary for the trust deed to limit distributions to family members, or to interposed entities who themselves only make distributions to family members. Alternatively, the trustee and interposed entities may, by way of an election, bind themselves to limit distributions to family members.

Thus, provided discretionary trusts are brought within the category of excepted family trusts (failing which they are to be subject to a continuity of control and a pattern of distributions test), it is unlikely that the trust loss carry-forward provisions will have a material impact upon them.

### Why is a discretionary trust such a tax-effective vehicle for trade and investment?

The answer to this question lies in the immediately preceding analysis. The discretionary trust, in appropriate circumstances, will be a highly effective investment vehicle because there will be no "claw-back", at beneficiary level, of any tax shelter available in the calculation of the net income of the trust estate. The benefit of both indexation of property cost bases, and depreciation allowances, will be fully maintainable at beneficiary level.

The same principles hold true for the use of a discretionary trust as a trading vehicle. If, on a disposal of goodwill, the sec 160ZZR 50% exemption operates to reduce the capital profit captured as a net capital gain (and accordingly the amount captured as net income of the trust estate), this shelter will also be fully maintainable at beneficiary level on a distribution of the sale proceeds by the trustee.

Use a company and the benefit of indexation and the sec 160ZZR partial exemption will, in the final analysis, be negated when sale proceeds are fully distributed. Use an inappropriately structured unit trust, and the benefit of indexation may be largely lost at unitholder level. Use a unit trust, however structured, and the benefit of the sec 160ZZR partial exemption will be largely lost at unitholder level.

In sum, it might at this stage in the analysis be said that it is only partnerships and **discretionary trusts** which will consistently allow investors and traders to pocket returns, without a negation or partial negation of tax shelters.

### What are the limitations upon the use of discretionary trusts as trading and investment vehicles?

There are two constraints upon the use of discretionary trusts. The first constraint is that any losses will be "locked up" in the trust estate, available only for offset against trust income, and then only if the trust meets prescribed tests for the carry-forward of revenue losses. The second constraint is inherent in the very nature of discretionary trusts in that they lend themselves only to situations in which the parties (beneficiaries) are prepared to abide by the trustee's exercise of discretionary powers. Accordingly, discretionary trusts are primarily "family" vehicles.

## 6. THE WAY FORWARD

Table 1 following is intended to allow for a ready comparison of the various vehicles by reference to the loss access and loss carry-forward rules, tax rates, the enduring availability of tax shelters on a full distribution of sheltered profits, and the ability to raise capital without onerous CGT consequences.

Tables 2 and 3 offer an alternative basis of comparison, by reference to the circumstances in which one or other vehicle might be said to be the vehicle of choice for the purpose of investment (Table 2) or trade (Table 3).

These tables have been compiled for your benefit to ascertain the most appropriate structure for your trade or investment. It will also show you that discretionary trusts are an effective and advantageous structure to take you into the next millennium. When you are ready to choose a structure for your investment or trade we suggest that you take the time to seek professional assistance to ensure that your choice is one that fits your needs.

<b>TABLE 1: KEY CHARACTERISTICS</b>				
	<b>LOSS ACCESS</b>	<b>LOSS CARRY-FORWARD</b>	<b>MAINTENANCE OF TAX SHELTERS ON DISTRIBUTION OF PROFITS</b>	<b>CAPITAL RAISING</b>
<b>PARTNERSHIP</b>	Partners have immediate access to losses	Depends on rules applicable to partner in question – ie whether individual or company	Full preservation of tax benefits at partner level	CGT exposures arise where partners dispose of interests in property on admission of new partner
<b>DISCRETIONARY TRUST</b>	Locked up in trust	If distributions limited to family members and/or entities making distribution to family member, will be generally be able to be carry losses forward indefinitely	Tax shelters fully maintainable at beneficiary level	Not applicable
<b>UNIT TRUST</b>	Locked up in trust	Subject to continuity of	Benefit of indexation fully maintainable at	Issue of units not a

		majority entitlements to income and capital. Alternative some business test only for listed unit trusts	beneficiary level if trust is fully capitalised. Section 160ZZR discount substantially negated on distribution of sale proceeds	"disposal" for CGT purposes
<b>COMPANY</b>	Losses transferable only between companies in same group	Subject to continuity of ownership and alternative same business tests	Tax shelters on corporate profits eliminated on full distribution to individual shareholders	Issue of shares not "disposal" for CGT purposes

**TABLE 2: IDEAL APPLICATIONS – INVESTMENT VEHICLES**

	<b>RELATIONSHIP BETWEEN PARTIES</b>	<b>TERM OF INVESTMENT</b>	<b>LEVEL OF GEARING</b>	<b>PROFIT DISTRIBUTION/RETENTION</b>
<b>PARTNERSHIP</b>	High degree of trust	Short to medium term	High	Always full distribution
<b>DISCRETIONARY TRUST</b>	Related parties	Not a key factor	Low – avoid running up trust losses	Generally full distribution
<b>UNIT TRUST (FULLY CAPITALISED)</b>	Primarily arm's length relationships	Not a key factor	Low – avoid running up trust losses	Full distribution of profits
<b>COMPANY</b>	Primarily arm's length relationships	Medium to long term to exploit 36% tax rate on retained profits	Low, unless losses transferable intra-group	Distribution only extent that dividend can be franked, medium to long term retention of balance

**TABLE 3: IDEAL APPLICATIONS – TRADING VEHICLES**

<b>PARTNERSHIP</b>	Must be a high degree of trust	Often vehicle of choice where losses in prospect	Access to Section 160ZZR discount determined by reference to value of partner's interest in
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			net worth – partners may qualify for discount even where net worth of partnership and associated businesses is well in excess of ordinarily applicable exemption threshold (\$2 million as indexed)
<b>DISCRETIONARY TRUST</b>	Related parties	Consider partnership when losses in prospect	Section 160ZZR exemption threshold applies in ordinary way
<b>UNIT TRUST</b>	Primarily arm's length parties	Consider partnership if losses in prospect and sufficient degree of trust	Not suited to small to medium sized enterprises - claw-back of Section 160ZZR discount on distribution of sale proceeds
<b>COMPANY</b>	Primarily arm's length parties	Consider partnership if losses in prospect and sufficient degree of trust	Not suited to small to medium sized enterprises - claw-back of Section 160ZZR discount on distribution of sale proceeds