

Checklist:

Discretionary Trusts

Acis.

Failing to effectively establish and operate a trust can lead to poor outcomes for you and your clients.

It's important to appreciate the need for effective establishment and operation of a trust, and to remember that the primary reasons for establishing trusts are:

- **Asset protection** – protecting assets from creditors of the trustee and beneficiaries
- **Tax planning** – achieving the best possible tax outcomes.
- **Estate planning** – achieving an intergenerational change of control of assets.

Getting this wrong may mean the trust's assets are exposed to personal creditor's claims, and/or more tax is payable than would otherwise be the case.

We've developed a simple diagnostic tool so you can:

- **Quickly identify any gaps in trust structures** – which may be easily addressed with a trust deed amendment;
- **Review trust deeds** – this should be done regularly to ensure the deed reflects changing circumstances and continues to provide for effective trust distributions; and
- **Understand the benefits of standardised terms** – this reduces the time you'll need to review your trusts deeds.

Please call us on 1800 773 477 if you have questions while completing the checklist or identify anything that needs attention.

Discretionary Trust Checklist

Please refer to the FAQs attached for a more detailed explanation of these issues.

1. Trust Establishment and Continuity FAQ 1

Has the deed been properly executed (FAQ 1.1)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Has the perpetuity date of the trust already passed? (FAQ 1.2)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Does the trustee hold a fully executed copy of the trust deed? (FAQ 1.3)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Is the trust dormant and/or should the trust be terminated (FAQ 1.4)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure

2. Beneficiaries and Distributions FAQ 2

Are proposed distributions for the current year authorised by the deed? (FAQ 2.1)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Are intended recipients actually beneficiaries? (FAQ 2.2)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Does the deed create a present entitlement? (FAQ 2.3)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Does the deed provide for default beneficiaries? (FAQ 2.5)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Are "Notional Settlers" excluded as beneficiaries? (FAQ 2.6)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Does the trust deed exclude foreign persons as beneficiaries (FAQ 2.6)		

3. Unpaid Entitlements FAQ 3

Do unpaid entitlements remain as UPEs and not loans (FAQ 3.1)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Does the deed contain a sub-trust provision? (FAQ 3.2)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Are there any unpaid entitlements to companies (FAQ 3.2)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure

4. Income and Capital FAQ 4

Does the deed contain a definition of income? (FAQ 4.1)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Is income defined as S95 income or some other method? (FAQ 4.2)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Can the trustee adopt different definitions or methods? (FAQ 4.3)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Can the trustee record amounts as income or capital? (FAQ 4.4)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Can the trustee record income in specific categories? (FAQ 4.5)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Can the trustee stream different classes of income (FAQ 4.5)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Can the trustee accumulate income rather than distribute? (FAQ 4.6)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Can the trustee treat accumulated income as income? (FAQ 4.8)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Can the trustee distribute capital gains before the trust ends? (FAQ 4.9)	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure
Can the trustee make in specie distributions? (FAQ 4.10) ▶CLICK HERE	<input type="checkbox"/> Yes	<input type="checkbox"/> No/Unsure

Discretionary Trust Checklist

5. Family Trust Election FAQ 5

Has a Family Trust Election been made? (FAQ 5.1) Yes No/Unsure

6. The Trust & Asset Protection FAQ 6

Does the deed provide effective asset protection? (FAQ 6.1) Yes No/Unsure

Has the trustee considered the powers of the Family Court? (FAQ 6.2) Yes No/Unsure

Is the trustee a company? (FAQ 6.3) Yes No/Unsure

7. Small Business Concessions FAQ 7

Has the trustee considered small business CGT concessions (FAQ 7.1) Yes No/Unsure

8. Current Provisions and Positions in the Trust FAQ 8

Does the deed contain an indemnity to the trustee (FAQ 8.1) Yes No/Unsure

Does the deed permit the Trustee to have a conflict of interest (FAQ 8.2) Yes No/Unsure

Are all of the trustee's powers up to date/bank compliant? (FAQ 8.3) Yes No/Unsure

Can the trustee amend the deed? (FAQ 8.4) Yes No/Unsure

Can this be done without consent of any other person? (FAQ 8.5) Yes No/Unsure

Are any schedules part of the deed? (FAQ 8.6) Yes No/Unsure

Does the trust deed allow appointment/removal of trustees (FAQ 8.7) Yes No/Unsure

Does the trust deed allow appointment/removal of appointors (FAQ 8.8) Yes No/Unsure

9. Estate Planning FAQ 9

Do the beneficiaries have an up to date estate plan? (FAQ 9.1) Yes No/Unsure

Does the deed work effectively with any estate plan? (FAQ 9.1) Yes No/Unsure

10. Resettlement FAQ 10

Is there a resettlement risk, CGT risk or stamp duty risk? (FAQ 10.1) Yes No/Unsure

Does the trust have any carry forward losses? (FAQ 10.1) Yes No/Unsure

Does the trust have any dutiable assets or capital gain assets? (FAQ 10.1) Yes No/Unsure

FAQs

FAQ 1 – Trust Establishment and Continuity

1.1

Where, by oversight or otherwise, a trust deed is not properly executed, significant validity issues can arise – at worst, the trust may not exist. If so, any distributions made may be invalid.

The Corporations Act 2001 provides a method for the execution of documents (including trust deeds) by companies – section 127 (the primary method relied upon) requires signature by company officers.

In each state/territory, legislation applies which deals with the execution of deeds by individuals. In all states except Victoria, the legislation requires an individual's signature to be witnessed by a third party.

Emergency Coronavirus response measures have been put in place by the Commonwealth and state/territory governments which facilitate electronic signatures for most documents – including deeds. Each of those measures is due to expire on a date specified in the enabling legislation/regulations in the relevant jurisdiction. Most of these measures have been extended temporarily and most jurisdictions have indicated that they will move to make the measures more permanent. However, you should seek professional advice to ensure an electronic signature is valid when dealing with company or deed execution.

1.2

If the trust's vesting day has already passed, the trust does not cease to exist. However, as a general rule, the terms of the trust deed will cease to operate. If the trust has already vested, and the trustee remains the legal owner of any trust assets, the trustee will hold them as a bare trustee with power only to make a final distribution to the beneficiaries entitled to them. Distributions made after the vesting day, whether of income or capital:

- (a) may trigger capital gains tax or transfer duty liabilities; and
- (b) may be invalid where the income or capital is not distributed to the proper beneficiaries (see FAQ 2.4 about default beneficiaries).

1.3

If a trust deed is lost, it should be replaced to ensure it's proper operation. In practice, in practice, provided you can show that the trust has been established,

a lost trust deed can be replaced by:

- (a) adopting a replacement trust deed;
- (b) seeking a declaration from a court of the validity and terms of the trust; or
- (c) both of the above

In all cases, the trustee must be able to show that the trust was validly established. It's generally recommended that the trustee contact the firm that prepared the trust deed and obtain a copy.

If that's not possible, the trustee may obtain a copy of the form of trust deed generally in use at the time by the firm that prepared it. The trustee must then establish, as closely as is possible, the terms of the trust as they existed at its establishment. If the trust deed was prepared by Acis after August 2006, we have an exact copy in our records. If prior to August 2006, we are likely to have all the relevant details and a pro forma deed that would have been used for the trust. If the trust deed was not prepared by Acis, we may still be able to provide a replacement trust deed.

Practitioners should be aware however, that there are limitations as to what can be done

to replace a lost deed. The trustee must be in a position to produce evidence of:

- (a) the valid creation of a trust; and
- (b) the original terms of the trust as contained in the original trust deed.

Without these there will always be some question as to whether adopting a replacement deed will be effective and enforceable

1.4

Trusts generally have a specific life – usually the statutory period of 80 years. At the end of the life of the trust, it will expire or terminate, by operation of law, unlike a company, which will continue to exist indefinitely, until it is wound up or deregistered. However, a trust will not end or cease to exist simply because it is dormant. Like a company, positive steps must be taken by the trustee to formally terminate the trust. Ideally this will be done by a vesting deed. Prior to vesting (terminating) the trust, all of the

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trust's income and assets should be distributed and all liabilities discharged. There may be tax or transfer duty issues to consider. (See also FAQ 1.2).

The steps to winding up include:

- preparing a vesting deed;
- discharging or setting aside funds as a provision for trust liabilities;
- providing for any contingent or other liability of the trust for tax and duty;
- lodging all outstanding returns and ensure the ATO cancels the trust's ABN/TFN.

FAQ2 – Beneficiaries and Distributions

2.1

Does the trust deed authorise the proposed distributions for the current year in the manner intended? Where the trust deed does not authorise the distributions being considered, those distributions may be invalid.

2.2

Are the intended recipients to whom distributions are to be made in the current year, actually beneficiaries according to the trust deed? If not, those distributions may be invalid.

2.3

Does the trust deed create a present entitlement/ indefeasible interest in a beneficiary immediately upon the trustee resolving to distribute to that beneficiary? The trust deed must create a right in each beneficiary to whom distributions are made, to call for the payment of the relevant amount by the trustee. Where the trust deed does not create a present entitlement, the intended distribution of income may be ineffective. Where the trust has income to which no beneficiary is presently entitled, tax may be assessed to the trustee under S99A of ITAA 1936 rather than to the beneficiaries.

2.4

Does the trust deed provide for beneficiaries who are takers in default of the trustee making a distribution? Default beneficiaries will be deemed to have received a distribution of income where the trustee fails to validly distribute income. Such a provision is intended to prevent

an assessment being issued to a trustee where ineffective distributions are made and where the trustee fails to distribute all income.

2.5

The Settlor of a trust is usually excluded from being a beneficiary and this is good practice. The exclusion is intended to avoid any suggestion that the trust is a revocable trust for the purposes of Section 102 of ITAA 1936. However, some trust deeds also exclude notional Settlers from being beneficiaries for the same reason. A notional Settlor is a person other than the original Settlor who at any time gives money or transfers assets to the trust at less than full value. It is highly likely any such person would be a potential beneficiary. Where a provision like this is present, any distribution to the "Notional Settlor" is probably invalid. Where that occurs, tax may be assessed to the trustee under S99A of ITAA 1936 rather than to the beneficiaries.

2.6

Most states/territories impose additional or surcharge transfer duty and/or land tax where a trust acquires or holds property and a foreign person would be included as a potential beneficiary. The descriptions of classes of beneficiaries in most discretionary trusts are usually extremely broad (giving the trust its inherent flexibility). However, because of this it is highly likely that a foreign person will be a potential beneficiary even if the trustee never distributes to them and does not intend to at any time. Each jurisdiction has different rules which will trigger the surcharge and most have different rates of surcharge. If the trust deed does not exclude foreign persons as beneficiaries, the trust deed may need to be amended to do so in order to avoid inadvertently being assessed at surcharge rates.

FAQ 3 – Unpaid Entitlements

3.1

Does the trust deed convert unpaid entitlements to loans? Where a trust deed creates a loan from an unpaid entitlement, the loan may be subject to Division 7A of ITAA 1936 by virtue of TR 2010/3, where the beneficiary is a company. Failure to comply with Div 7A may result in a deemed dividend paid by the company beneficiary to the trust. Tax will usually become payable at the highest marginal rate and without the benefit of a franking credit.

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FAQ 3 – Unpaid Entitlements

3.2

Does the trust deed contain a sub trust provision that states that distribution amounts set aside as unpaid entitlements of beneficiaries are held in a separate or sub trust? If it does it may be possible to treat unpaid distributions to companies as not subject to Div 7A. To avoid a company UPE being treated as a Div 7A deemed dividend, the trustee of the trust must take certain steps to ensure that the company is not financially accommodating the trust by allowing the trustee to retain the funds for use within the trust. This can be done by placing the funds in a separate sub-trust for the sole benefit of the company. The trustee may invest the funds held in the sub-trust back into the main trust on commercial terms, so that the main trust continues to have access to those funds. However, the trust and the company must enter into a binding investment agreement. (See PS LA 2010/4).

FAQ 4 – Income and Capital

4.1

If there is no definition of income in the trust deed, the trustee is only permitted to deal with trust law income as income of the trust – that is, income which would be treated as income under trust law. All other amounts would be classified as trust capital. Capital gains are not trust law income, for example, and cannot be distributed as income by the trustee, in the absence of a definition that treats capital gains as income. Distributions of taxable capital gains as income in those circumstances may be ineffective and may result in the trustee being taxed on the gains or may result in a different tax outcome to the one intended.

4.2

Is income defined as accounting/distributable income, S95 income, a combination of these or some other method? Ideally the trust deed will permit all or any of these and permit the trustee to use whichever method of determining income to achieve the best tax position for the trust and the beneficiaries. Without such flexibility, distributions may be ineffective and may result in the trustee being taxed on trust income or may result in a different tax outcome to the one intended.

4.3

Does the trust deed contain a discretion for the trustee to adopt different definitions or methods of calculating

income in different years? Ideally, the trust deed will permit the trustee to use different methods of determining income in different years to achieve the best tax position for the trust and the beneficiaries each year.

4.4

Does the trust deed permit the trustee to record any receipts/outgoings or revaluations as income or capital? Ideally, the trust deed will give the trustee a discretion to account for all or any amounts received, or paid, by it as income or capital. This permits the trustee to manage the effective distributable income of the trust ensures the trustee is able to fully distribute all income to achieve the best tax position for the trust and the beneficiaries.

4.5

Does the trust deed allow the trustee to record income in specific categories and from specific sources? In order to effectively stream different types of income, the trustee must be permitted by the trust deed to account separately for different types of income.

4.6

Does the trust deed allow the trustee to stream different classes of income to different beneficiaries? In order to effectively stream income, the trustee must be permitted by the trust deed to separately distribute different classes of income to different beneficiaries.

4.7

Does the trust deed permit the trustee to accumulate income rather than distribute it? It may be advantageous or desirable for the trustee to retain income within the trust, from time to time. Where the trust deed does not permit accumulations, any retention by the trustee will be ineffective where the trust deed provides for a default distribution. This results in default beneficiaries becoming entitled to and being taxed on the undistributed income of the trust.

4.8

Does the trust deed allow the trustee to treat accumulated income as income in future years rather than adding it to capital? In the absence of such a provision, any distribution of accumulated income will be a deemed distribution of capital. Note that the ATO will treat any accumulated income as capital regardless of the terms of the trust deed.

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FAQ 4 – Income and Capital

4.9

Does the trust deed permit the trustee to distribute capital and/or capital gains before the trust ends and at the trustee's discretion? Where the trust deed does not allow the trustee to distribute capital prior to the vesting day of the trust, capital and capital gains may be trapped in the trust and not distributable until then.

4.10

Does the trust deed permit the trustee to make distributions of income or capital by an in specie transfer of trust assets? It may be desirable for the trustee to transfer trust assets to a beneficiary in satisfaction of an entitlement to income or capital. In the absence of such a provision, the trustee may be required to convert trust assets to cash (by sale for instance) or to borrow in order to make a distribution. This may have tax consequences and will usually present timing issues for the trustee to consider.

FAQ 5 – Family Trust Election

5.1

Has a Family Trust Election (FTE) been made which might restrict distributions? Making a FTE may prevent a trustee from making distributions to certain persons/entities.

A FTE is an election that is made in order to make the trust a family trust for taxation purposes. The election must specify a year of income from which it is to take effect. It must also specify one individual whose family group is to be taken into account. Where a trust makes a FTE, distributions may only be made to beneficiaries who are within the family group. Any distributions outside the family group will be taxed at the highest marginal rate applying to individuals plus Medicare levy.

FAQ 6 – The Trustee & Asset Protection

6.1

Does the trust deed work effectively for asset protection of trust and/or personal assets? In order to achieve effective asset protection using a trust, the overriding principle is to separate risk from assets. The trust should not be established in such a way that any "at risk" person

has sole control of trust assets – some commentators suggest that such a person should have no direct control of trust assets. For that reason, it is critical that, when structuring and administering any discretionary trust, the roles of the Trustee (and directors and shareholders of corporate trustees), Appointor and beneficiaries are carefully considered. Where an existing trust does not possess the recommended characteristics, it may be necessary/desirable to amend the trust deed to achieve this.

6.2

Has the trustee considered the effect of Family Court jurisdiction on the issue of asset protection? The Family Court has extremely broad jurisdiction to make orders regarding the distribution of assets in marital matters. In some cases the Family Court may:

- (a) treat trust assets as marital assets and make orders that trust assets be transferred to one or other of the parties to a marital dispute;
- (b) treat trust assets as a financial resource of one party to the dispute.

6.3

Ideally, the trustee should be a company. The primary concern around using a corporate trustee is one of asset protection. The overriding principle is to separate risk from assets.

Because trusts are not considered to be legal entities, when trusts operate there must be a person or other legal entity that becomes primarily responsible for the debts of the trust and who can act on behalf of the trust. This is the trustee. Trustees incur personal liability for the debts of the trust. The trustee is entitled to be indemnified for any personal liability by recouping any such amount out of the assets of the trust. However, if the trust does not have sufficient assets to pay that liability for the trustee, the trustee is personally responsible for the payment of the trust's debts. The trustee is responsible for those liabilities whether or not the trust has sufficient assets. Any individual trustee who cannot claim against the indemnity has his or her personal assets exposed to the claims of creditors of the trust.

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FAQ 6 – The Trustee & Asset Protection

6.3 (cont.)

A number of cases have highlighted the need for separation of the "at-risk" person in a trust situation from trust assets. The use of a company as the trustee of a trust can provide a greater level of asset protection than the appointment of an individual as trustee.

Most trust deeds also prohibit certain individuals from being trustees. For example, the settlor is commonly excluded. However, some trusts also prohibit a beneficiary from being a trustee. Some jurisdictions (for example, NSW) impose duty on a transfer of assets from one trustee to another when the trustee is changed. Using a corporate trustee may avoid these problems.

FAQ 7 – Small Business Concessions

7.1

Has the trustee considered the application or availability of small business CGT concessions to the trust in the event of the sale of a significant trust asset? Various threshold tests must be satisfied before small business CGT concessions become available under Div 152 of ITAA 1997. Great care needs to be exercised in determining the timing of the relevant CGT event, the identity of affiliates/connected entities of the trust and the maximum net asset value of assets for the application of the tests.

FAQ 8 – Current Provisions and Positions in the Trust

8.1

Does the trust deed contain an indemnity in favour of the trustee? Trustees are personally liable for all of the liabilities of the trust and incurred in the capacity as trustee. While the law implies an indemnity that allows the trustee to be reimbursed for any such liabilities incurred by the trustee, it is limited. Ideally, the trust deed will contain a provision that significantly extends the indemnity on which the trustee may claim. (See also FAQ 6.)

8.2

Does the trust deed permit the trustee to have a personal interest/conflict of interest in transactions involving the trust and is the trustee permitted to be a beneficiary and to receive trust income/capital? Where the trustee has a conflict of interest when carrying out a transaction, under common law, a breach of trust may result and void the relevant transaction. Similarly, if the trustee is not a beneficiary, any distribution may be invalid.

8.3

Are all of the trustee's powers up to date/bank compliant? The trustee is only permitted to act in accordance with powers specified in the trust deed. Any transaction that is not supported by an express power may be invalid, resulting in a breach of trust. Banks and other institutions regularly find trust powers to be insufficient for their purposes and require amendments to ensure the efficacy of a transaction and/or to ensure no breach of trust arises.

8.4

Does the trust deed contain a power for the trustee to amend the trust deed in order to resolve any deficiencies in any relevant provision referred to in this checklist? The trustee cannot amend the trust deed to address any deficiencies or to improve the efficacy of the trust deed in the absence of a power to amend. Not all amendment provisions are sufficiently broad to permit all amendments.

8.5

Is the consent of any person required before the trustee can validly amend the trust deed? Failure to obtain any consent required by the trust deed may invalidate any attempted amendment.

8.6

Are all schedules in the trust deed actually part of the trust deed and can they be amended in accordance with the trust deed's amendment powers? If the trust deed does not make any schedules or other annexures to the trust deed, a part of the trust deed, an amendment power may not authorise the amendment of provisions appearing in schedules/annexures. Any attempted amendment of such provisions may be invalid.

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FAQ 8 – Current Provisions and Positions in the Trust

8.7

Does the trust deed contain up to date provisions for the appointment and/or removal of trustees? Where the trust deed does not contain an effective mechanism for the replacement of trustees, the trust deed may lose flexibility and may make it difficult or impossible to change the trustee. This may adversely affect asset protection and estate planning measures or at worst leave the trust without a trustee which would require an application to the court to rectify.

8.8

Does the trust deed contain up to date provisions for the appointment and/or removal of principals/appointors? Where the trust deed does not contain an effective mechanism for the replacement of principals/appointors, the trust deed may lose flexibility and this may make it difficult or impossible to change the principal/appointor. This may adversely affect asset protection and estate planning measures.

FAQ 9 – Estate Planning

9.1

Do the beneficiaries have an up to date estate plan? Does the trust deed work effectively with, or has it been considered in the context of, the beneficiaries' estate plans (if any)? Many people assume that a trust will terminate and/or that assets held in a trust will become available to the estate of a deceased beneficiary. However, trust assets are not personal assets and do not devolve on death. The death of a specified person will generally not result in the termination of the trust nor the trust assets becoming available to beneficiaries of the deceased's estate. Accordingly, the management of the trust assets and, particularly, the control of the trust is very important in achieving the outcomes desired by the specified person. Without an effective estate plan, trust assets may come to be controlled by persons who are not those desired by the specified person, or may become available to persons that the specified person wishes to exclude.

FAQ 10 – Resettlement

10.1

Is there a, CGT/tax risk or duty risk in making changes to the trust deed to address any of the issues identified above? Whether a particular change triggers CGT/tax or duty will depend on the relevant legislative provisions. These include ITAA 1936 and 1997 as well as the duty legislation in each state/territory (amongst others). Occasionally, changes will reset the trust although resettlement seems to be a lower risk since Clark's case in 2011. Resettlement means that, by some action or change relating to the trust, a new trust is created. Primarily, resettlement occurs when a change is made to the trust, which fundamentally changes the relationship of the trustee and the beneficiaries. The change in question is sufficiently significant to terminate the trust, and create a new one. If that occurs, there is a notional disposal of all of the trust assets. This may result in CGT or duty liabilities.

Clark's case and TD 2012/21 confirm that, in the ATO's view, any amendment carried out in the valid exercise of a power of amendment contained in the trust deed would be effective and should not result in CGT event E1 or E2 occurring.