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LAWYERS

Using a Trust to operate your business

The political spotlight is increasingly being shone on trusts with ever more vociferous claims being made about their use as vehicles for tax avoidance or tax minimization, particularly in respect to the operation of businesses. So, what exactly are trusts and how can you use them in conducting your business activities?

What is a Trust?

A frequently held, but incorrect view, is that a trust is a legal entity or person, like a company or an individual. But this is not the case and is possibly the most misunderstood aspect of trusts.

A trust is not a separate legal entity - it's essentially a relationship that is recognised and enforced by the Courts in their "equitable" jurisdiction. Put simply, a trust is a relationship which exists where A holds property for the benefit of B. A is known as the trustee and is the legal owner of the property which is held on trust for the beneficiary B. The trustee can be an individual, group of individuals or a company. There can be more than one trustee and there can be more than one beneficiary. Where there is only one beneficiary the trustee and beneficiary must be different if the trust is to be valid.

The Courts will generally strictly enforce the nature of the trustee's obligations to the beneficiaries so that, while the trustee is the legal owner of the relevant property, the property must be used only for the benefit of the beneficiaries. Trustees have what is known as a fiduciary duty towards beneficiaries and the courts will always enforce this duty rigorously.

Types of Trusts used to operate a Business

When looking to establish a business there are a number of business structures that can be utilised by a business owner. These include operating as a sole trader, operating in partnership with other individuals under a partnership arrangement, incorporating a company to own and operate the business or establishing a trust to own the business. Each of these business ownership structures have varying implications in respect to the issues of asset protection, taxation and business succession. In general terms, the following types of trusts are most frequently encountered in the operation of a business or for asset protection by business owners:

- Discretionary trusts – "Family Trusts"
- Unit trusts
- Fixed trusts
- Hybrid trusts

Discretionary Trusts – "Family Trusts"

These are often called "family trusts" because they are usually associated with tax planning and asset protection for a family group. In a discretionary trust the beneficiaries do not have any fixed interests in the trust income or its property but the trustee has a discretion to decide whether anyone will receive income and/or capital and, if so, how much.

For the purposes of trust law, a trustee of a discretionary trust could theoretically decide not to distribute any income or capital to a beneficiary, however, there are tax reasons why this course of action is usually not taken.

The attraction of a discretionary trust is that the trustee has greater control and flexibility over the disposition of assets and income since the nature of a beneficiary's interest is that they only have a right to be considered by the trustee in the exercise of his or her discretion. From a business ownership perspective, operating a business via a discretionary trust structure enables to the profits of the business to be distributed among a wider range of recipients (the trust beneficiaries) other than to just the person or entity who runs the business, with each beneficiary receiving the benefit of the progressive tax scale.

As an example, a student agent 18 or over and any other beneficiary who was not already receiving an income, could be paid income from the trust and generally would not start paying tax until their income exceeded $18,200 per annum. If there were five beneficiaries in this category, the trust could effectively distribute $91,000 of the profits received by the business without any tax being paid on such amount.

Unit Trusts

These are generally fixed trusts where the beneficiaries and their respective interests are identified by their holding "units" much in the same way as shares are issued to shareholders of a company. The beneficiaries are usually called unitholders and it's is common for businesses with multiple owners and joint ventures to be structured as unit trusts.

There are no limits in terms of trust law on the number of units/unitholders, however, for tax purposes the tax treatment can vary depending on the size and activities of the trust. The beneficiaries can also transfer their interests in the trust by transferring their units to a buyer subject to the terms of the unit trust.

Fixed Trusts

In essence these are trusts where the trustee holds the trust assets for the benefit of specific beneficiaries in certain fixed proportions. In such a case the trustee does not have to exercise a discretion since each beneficiary is automatically entitled to his or her fixed share of the capital and income of the trust.

Hybrid Trusts

These are trusts which have both discretionary and fixed characteristics. The fixed entitlements to capital or income are dealt with via "special units" which the trustee has power to issue.

Establishing a Trust

Although a trust can be established without a written document, it is preferable to have a formal deed known as a declaration of trust or a deed of settlement. The declaration of trust involves an owner of property declaring themselves as trustee of that property for the benefit of the beneficiaries. The deed of settlement involves an owner of property transferring that property to a third person on condition that they hold the property on trust for the beneficiaries.

The person who transfers the property in a settlement is said to “settle” the property on the trustee and is called the “settlor”.

In practical terms, the original amount used to establish the trust is relatively small, often only $10 or so. More substantial assets or amounts of money are transferred or loaned to the trust after it has been established. The reason for this is to minimise stamp duty which is usually payable on the value of the property initially affected by the establishing deed.

The identity of the settlor is critical from a tax point of view and it should not generally be a person who is able to benefit under the trust, nor be a parent of a young beneficiary. Special rules in the tax law can affect such situations.

Also critical to the efficient operation of a trust is the role of the “appointor”. This role allows the named person or entity to appoint (and usually remove) the trustee, and for that reason, they are seen as the real controller of the trust. This role is generally unnecessary for small superannuation funds (those with fewer than five members) since legislation generally ensures that all members have to be trustees.

The Trust Fund

In principle, the trust fund can include any property at all – from cash and business goodwill and equipment to business premises. Trust deeds usually have wide powers of investment however, some deeds may prohibit certain forms of investment.

The critical point is that whatever the nature of the underlying assets, the trustee must deal with the assets having regard to the best interests of the beneficiaries. Failure to act in the best interests of the beneficiaries would result in a breach of trust which can give rise to an award of damages against the trustee.

Powers and Duties of a Trustee

A trustee must act in the best interests of beneficiaries and must avoid conflicts of interest. The trustee deed will set out in detail what the trustee can invest in, the businesses the trustee can carry on and so on. The trustee must exercise powers in accordance with the deed and this is why deeds tend to be lengthy and complex so that the trustee has maximum flexibility.

Who can be a Trustee?

Any legally competent person or a company can act as a trustee. Two or more entities can also be trustees of the same trust.

A company can act as trustee (provided that its constitution allows it) and can therefore assist with limited liability, perpetual succession and other advantages. The company’s directors control the activities of the trust and the trustees’ decisions should be the subject of formal minutes, especially in the case of important matters such as beneficiaries’ entitlements under a discretionary trust.

Income Tax and Capital Gains Tax Issues

Because a trust is not a person, its income is not taxed like that of an individual or company unless it is a corporate, public or trading trust as defined in the Income Tax Assessment Act 1936. In essence the tax treatment of the trust income depends on who is and is not entitled to the income as at midnight on 30 June each year.

If all or part of the trust's net income for tax purposes is paid or belongs to an ordinary beneficiary, it will be taxed in their hands like any other income. If a beneficiary who is entitled to the net income is under a "legal disability" (such as an infant), the income will be taxed to the trustee at the relevant individual rates.

Income to which no beneficiary is "presently entitled" will generally be taxed at highest marginal tax rate and for this reason it is important to ensure that the relevant decisions are made as soon as possible after 30 June each year and certainly within 2 months of the end of the year. The two month "period of grace" is particularly relevant for trusts which operate businesses as they will not have finalised their accounts by 30 June. In the case of discretionary trusts, if this is done the overall amount of tax can be minimised by allocating income to beneficiaries who pay a relatively low rate of tax.

The concept of "present entitlement" involves the idea that the beneficiary could demand immediate payment of their entitlement.

It is important to note that a company which is a trustee of a trust is not subject to company tax on the trust income it has responsibility for administering.

In relation to capital gains tax (CGT), a trust which holds an asset for at least 12 months is generally eligible for the 50% capital gains tax concession on capital gains that are made. This discount effectively "flows" through to beneficiaries who are individuals. A corporate beneficiary does not get the benefit of the 50% discount. Trusts that are used in a business rather than an investment context may also be entitled to additional tax concessions under the small business CGT concessions.

Trusts which incur losses

One of the most fundamental things to understand about trusts is that losses are "trapped" in the trust. This means that the trust cannot distribute the loss to a beneficiary to use at a personal level. This is an important issue for businesses operated through discretionary or unit trusts.

Why a Trust and which Type?

Apart from any tax benefits that might be associated with a trust, there are also benefits that can arise from the flexibility that a trust affords in responding to changed circumstances.

A trust can give some protection from creditors and is able to accommodate an employer/employee relationship. In family matters, the flexibility, control and limited liability aspects combined with potential tax savings, make discretionary trusts very popular.

In arm's length business ventures, however, the parties prefer fixed proportions to flexibility and generally opt for a unit trust structure, but the possible loss of limited liability through this structure commonly warrants the use of a corporate entity as unitholder (i.e. a company or a corporate trustee of a discretionary trust).

Trusts are a fundamental element in the planning of business, investment and family financial affairs. However, there are strengths and weaknesses associated with trusts and it's important to understand what they are and how the trust will evolve with altered circumstances particularly as your business grows or your personal circumstances change.

If you want to know more about establishing a trust for your business or personal activities or would like assistance with any business matter, please call John Bateman or Michael Battersby on 02 4731 5899 or email commercial@batemanbattersby.com.au.