Many individuals and companies use various types of trusts to manage and protect their assets. This article will discuss discretionary (or family) trusts in some detail, including the advantages and disadvantages of implementing a discretionary trust.

A. INTRODUCTION – WHAT IS A DISCRETIONARY TRUST?

A trust is a relationship (or agreement) in which a party or parties (the trustee/s) hold an asset for the benefit of another party or parties (the beneficiary/ies). Essentially, the trustee is the legal owner of the assets and holds the assets on trust for the beneficiary who has an interest in the assets. Trusts are enforceable in court as equitable jurisdictions recognise that a fiduciary duty exists between the trustee and beneficiary. Trusts are generally created and maintained through a trust deed, which sets out the terms and conditions for how the trust will operate.

In a discretionary trust (most commonly known as a family trust), the trustee has discretion in managing and choosing the benefit offered by the trust. Discretionary trusts are popular amongst families because the trustee (generally a senior family member) can choose and control what the beneficiaries receive.

B. KEY MEMBERS INVOLVED IN A DISCRETIONARY TRUSTS

B.1. TRUSTEES

The trustee is the legal owner of the assets held in the trust. Accordingly, the trustee's role is to be responsible for the trust and to manage its assets. A trustee can be a single person, multiple people, or a company. Generally, the trustees for a discretionary trust are the parents or grandparents of a family. Trustees are appointed either through the express terms of a trust instrument, by statute,[1] or by court appointment.[2] It is also common for a family to incorporate a company for the sole purpose of acting as the trustee, with senior members of the family being the directors and shareholders of the company.

The duties and powers of the trustee are set out within the trust deed, in equity and through legislation such as the Trustee Act 1925 (NSW). If a trustee fails to comply with their duties, it is considered a breach of trust. Examples of trustee duties include:

- The duty to make inquiries (eg seeking advice about clauses of the trust deed before deciding to invest or sell trust property);[3]
- The duty to exercise reasonable care;[4]

[1] *Trustee Act 1925* (NSW) s 6.
[2] Ibid.
[3] *Turner v Turner* [1984].
[4] *Permanent Building Society v Wheeler* (1994).

- The duty to obey the terms of the trust;[5] and
- The duty to keep proper and accurate accounts that are up to date.[6]

Trustee powers are distinct to trustee duties in that trustee powers are discretionary, with trustee's acting where they think fit. Courts do not generally interfere unless the nature of the power is misconceived or abused by the trustee.[7] Trustees are required to exercise their powers in good faith and after genuinely considering their actions.[8] Examples of trustee powers include being able to sell trust property, and being able to appoint lawyers and investment advisors.

In most circumstances, if a trustee is found to have breached his or her duties and acted in a manner where he or she does not have the power to do so, the trustee may be held personally liable for any loss incurred. Remedies available to beneficiaries for breach of trust can include restoration of trust fund;[9] compensation;[10] and/or an account of profits.[11]

B.2. BENEFICIARIES

Beneficiaries are those with an interest in the trust as assets are held by the trustees for their benefit. A beneficiary can be a single person, multiple people, or a company. Generally, the beneficiaries for a discretionary trust are the children and/or grandchildren of a family. A trustee can also be a beneficiary, but cannot be the sole beneficiary if there is no other trustee. The trust deed will specify the class (or groups) or beneficiaries who can receive a benefit from the trust. For instance, the trust deed may establish that the primary beneficiaries are children of the trustees and secondary beneficiaries are grandchildren of the trustees.

In a discretionary trust, beneficiaries do not have a 'vested' or 'proprietary' interest like they would in another type of trust (such as a fixed unit trust). Accordingly, beneficiaries only have a 'mere expectancy' of receiving income from the trust. This is because beneficiaries in a discretionary trust do not have a right (or entitlement) to receiving a benefit from the trust. Rather, trustees have the discretion and flexibility to distribute income (or assets) amongst the beneficiaries as they see fit.

C. ADVANTAGES OF A DISCRETIONARY TRUST

Discretionary trusts are popular because they offer many advantages such as asset protection and estate planning, flexibility over income distribution and tax benefits.

C.1. ASSET PROTECTION AND ESTATE PLANNING

A discretionary trust is useful since it can protect assets from creditors because the trustee holds the assets in the trust for the benefit of others (and not for him or herself). As such, creditors of the trustee generally cannot take assets held in the trust (unless it is a trust debt). Similarly, creditors of beneficiaries are usually unable to take trust property because they are not the legal owners of the assets.

Discretionary trusts are also useful for estate planning purposes as they can keep assets from falling into the hands of creditors when the beneficiary is bankrupt. This is because creditors are generally unable to claim an estate that is left to a discretionary trust for the benefit of the beneficiary (eg parents die and leave everything to a discretionary trust that is created for the benefit of their only child). Comparatively, a creditor could claim the estate it is left directly to an individual that is bankrupt (eg parents die and leave everything to their only child who is bankrupt).

[5] *Youyang Pty Ltd v Minter Ellison Morris Fletcher* (2003).
[6] *Struss v Wykes* [1916].
[7] *Mannville v Crompton* (1813).
[8] *Patridge v The Equity Trustees Executors and Agency Co Ltd* (194
[9] *Re Dawson* [1996].
[10] Ibid.
[11] *Chan v Zacharia* (1984).

C.2. FLEXIBILITY OVER DISTRIBUTING INCOME

Another benefit of discretionary trusts is that trustees have control and can choose the benefit received by beneficiaries (if any) in each given year.

For example, the trustees could choose to allocate trust property in any of the following ways:

- 40% to A, 40% to B, 20% to C
- 100% to A, 0% to B, 0% to C
- 10% to A, 55% to B, 35% to C

This flexibility is also useful because it allows trustees to effectively distribute income each year by assessing their tax position and the assessable income of the beneficiaries.

C.3. TAX BENEFITS

Discretionary trusts are popular amongst families because it can reduce the overall tax paid by a family unit. A discretionary trust does not have to pay income tax on income distributed to beneficiaries. Rather, each beneficiary pays tax on the distributions made to them because it forms part of their assessable income. This can be beneficial as trustees can take advantage of the marginal tax rates that apply to the beneficiaries. For instance, a trustee may decide to distribute a significant proportion of trust income to a beneficiary with the benefit of the tax-free threshold.

Another tax benefit is that the trust may be eligible for a 50% capital gains tax concession if assets held by the trust are distributed to individual beneficiaries after being held for one year.

D. DISADVANTAGES OF DISCRETIONARY TRUSTS

While there are several advantages associated with discretionary trusts, individuals should consider the disadvantages before they decide to set one up.

D.1. TAX DRAWBACKS

Discretionary trusts are not designed for purposes of accumulating trust income. This is because a discretionary trust will be heavily taxed (at the top marginal tax rate) on any undistributed income. Moreover, only profits can be distributed to beneficiaries and losses can therefore not be used to lower the taxable income of a beneficiary.

It is also important to note that penalty rates at the top marginal tax rate may also be applicable to distributions made to minors. Trustees should therefore exercise caution when allocating income to minors.

D.2. COSTLY AND COMPLEX

Depending on the complexity of the trust, fees can quickly add up in both setting up and administering the trust. Additionally, stamp duty may also be payable when creating the trust.

D.3. TRUSTEE LIABILITY AND COMPLIANCE

Trustees can be held personally liable if they breach their duties or act outside the scope of their powers. Trustees can also be held personally liable for any trust debts that they incur. In this case, assets held within the trust are not protected.

E. CONCLUSION

Discretionary trusts are popular amongst wealthy family units because of the many advantages they can provide. Comasters Law Firm can help clients set up and administer a discretionary trust.

Comasters is able to set up and administer discretionary trusts.

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