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Guide to discretionary trusts

This guide explains some key discretionary trust concepts and highlights important advice considerations.

Background

Trusts can be a valuable structure to hold investments. A trust is commonly established to:

- provide for family and children, including disabled beneficiaries
- allow flexibility to make income and capital distributions to family members
- protect assets from creditors in the event of bankruptcy
- allow intergenerational transfer of wealth
- take advantage of income splitting
- provide a wealth creation vehicle as an alternative to superannuation
- allow pooling of resources for greater diversification and purchases of larger valued assets.

A trust is a structure whereby an asset(s) is legally owned and controlled by the trustee for the benefit of its beneficiaries. It may hold passive investments (eg shares, property and cash) or own and operate a business.

Where your client has an existing trust structure, you should understand:

- what benefits the trust offers your client
- how it can be used effectively in the financial planning process
- the social security treatment of trust income and assets
- the taxation treatment of trust income (including assessable capital gains)
- the estate planning implications of the trust.

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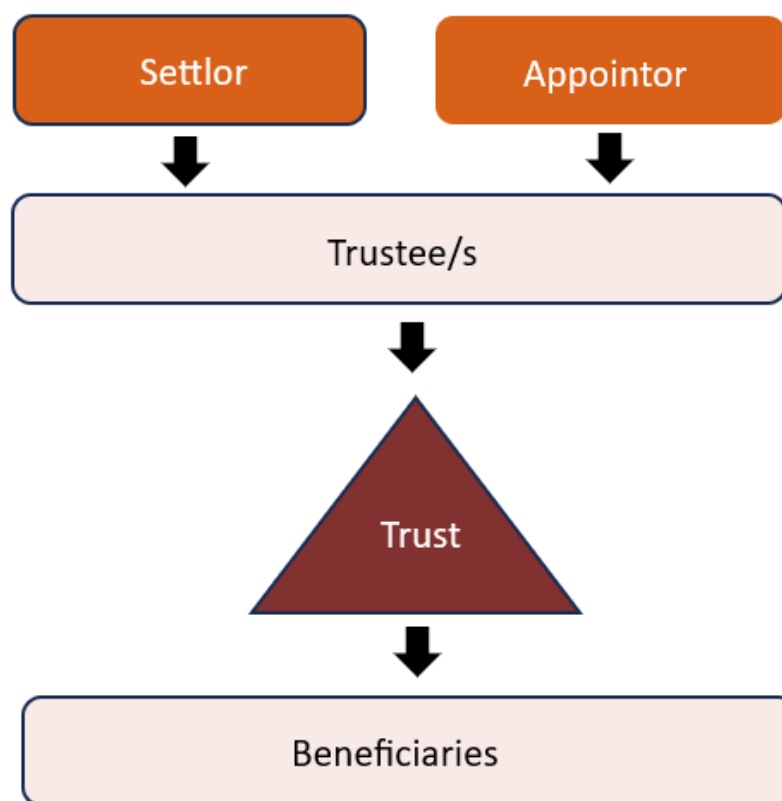
General trust concepts

A trust is not a separate legal entity but rather a fiduciary relationship. Trusts can have a maximum life of up to 80 years¹ (except South Australia where there is no maximum life before vesting), at which point the trust comes to an end, or 'vests'. Depending on the State/Territory or the trust deed, the trust may be required to vest at an earlier point.

Although SA has no time limit of trusts, if the trust holds real property and other assets in another Australian jurisdiction, these may be subject to that jurisdiction's trust law, including its rule against perpetuities.

The 'who's who' of trusts

There are several roles when establishing and maintaining a trust.



Settlor

The settlor creates the trust by executing the trust deed and placing an asset, usually a nominal amount of money (eg \$10), in trust for the beneficiaries.

The settlor should not, have any other role in the trust, be a trust beneficiary, or parent of a minor beneficiary, to avoid unintended tax implications. A close family member, relative or an unrelated third party could fulfil this role.

¹ Known as the 'rule against perpetuities'

Trustee

The trustee holds legal ownership of trust assets for the benefit of the beneficiaries and determines how distributions are made in accordance with the trust deed. The trustee may be an individual(s) or a company.

The title to trust assets will generally be in the trustee's name as trustee for the trust eg John Citizen as trustee for XYZ Family Trust, or XYZ Pty Ltd as trustee for XYZ Family Trust. Where an authority does not allow this naming convention, an appropriate declaration of trust or legal instrument should be in place. A declaration of trust contains a declaration from the legal owner that they are holding the asset in trust for another entity.

Various state/territory trustee laws place certain fiduciary responsibilities on trustees. In general, a trustee:

- is under an obligation to deal with the assets of the trust in accordance with the trust deed
- must exercise the level of care, diligence and skill of a prudent person, and
- must regularly review the performance of trust investments at least annually².

Trustees must consider the following when investing the assets of the fund:

- the purposes of the trust, plus the needs and circumstances of the beneficiaries
- the desirability of diversifying trust investments
- the nature and risk associated with existing trust investments and other trust property
- the need to maintain the real value of the capital or income of the trust
- the risk of capital loss or depreciation, and the potential for capital appreciation
- the likely income returns and its timing
- the length of a proposed investment, and the overall probable duration of the trust.

Trustees who breach their duties leave themselves open to potential legal action where they breach their fiduciary obligations. Accordingly, trustees should keep written records of all assets and minute all trustee decisions.

If the trustee is a company, it is controlled by its directors. The trustee may be personally liable for any debts of the trust, however, ordinarily they are indemnified against the assets of the trust. An advantage of having a corporate trustee is that liability is generally limited to company assets. Ideally the company should not act as trustee of other trusts, hold other assets or run a business. The use of a special purpose company may help:

- avoid issues arising in respect to the ownership and title of certain investments
- aid in the maintenance of accurate financial statements, and
- provide protection of assets in the event of a claim against the trustee.

Appointor

Some trusts have an appointor. The appointor can remove or appoint trustees in accordance with the trust deed, and so, has effective control of the trust. New appointments may be needed where circumstances change such as where a trustee retires, dies, or cannot fulfill their trustee duties. The appointor has the power to nominate a successor if the trust deed permits. For that reason, the client must carefully consider who the appointor should be. While it is not a requirement to have an appointor identified in the trust deed, it is considered best practice to have one to deal with the death, insolvency or incapacity of trustee(s). A single appointor may be selected, or multiple appointors can be appointed to act jointly.

Beneficiaries

The beneficiaries are the people or companies for whose benefit the trust is created and administered. The trust deed may prescribe different classes of beneficiaries. For example, there may be primary beneficiaries who are explicitly mentioned in the trust deed and a range of secondary beneficiaries, who are defined by their relationship to the primary beneficiaries.

² This is an example taken from Trustee Act 1925 s14A (NSW).

For example, John and Jane Smith are primary beneficiaries and the children and grandchildren of John and Jane are secondary beneficiaries). In addition, beneficiaries can be differentiated based on their interest in the trust. For example, the trust deed may stipulate certain beneficiaries may receive income only or assets (capital) only or both. It is generally prudent to include residual or default beneficiaries in the trust deed who can receive distributions if all other potential beneficiaries have deceased and for tax reasons.

Establishing the trust

Several steps are involved in establishing a trust. The trust should be established by the client's legal adviser who arranges all the necessary documentation, including the trust deed.

Steps in forming a trust

Determine beneficiaries

There is generally no legislative restriction as to who a beneficiary of a trust can be. Some trusts may restrict the range of beneficiaries to obtain a beneficial tax or social security treatment or to protect trust assets. Beneficiaries may include:

- an individual
- a trustee of another trust
- a company, or
- a charity.

Different types of trusts are set up for different purposes. Examples include family trusts, special disability trusts, super proceeds trusts and testamentary trusts.

Establish the trust deed

It is not a legal requirement for a trust to be established in writing, however there are many compelling reasons why this is generally the preferred approach.

The trust deed is the document setting out the trust purpose, rights and obligations of the trustee and the beneficiaries. It outlines the governing rules, investment guidelines and how benefits are paid to beneficiaries. A trust deed should be drafted by a suitably qualified lawyer.

Where a trust deed is silent on a particular issue, the relevant statute or common law will apply. Stamp duty may be payable on the creation of the trust deed and may vary across the states and territories.

Some of the things the trust deed should address include:

- the objectives of the trust
- nominated beneficiaries
- the types of investments the trustee can make on behalf of the beneficiaries
- any requirement that a beneficiary has only an income or capital interest in the trust
- any requirement that a beneficiary attain a particular age prior to receiving an interest in the trust
- any requirement that certain types of income be streamed to certain beneficiaries
- the trust deed must be signed and dated by all trustees.

The trust deed should be reviewed regularly and updated as required.

Advice tip

When providing investment advice to trustees of a trust in respect of trust assets, consider any objectives specified in the trust deed. For example, an objective to fund tertiary education costs and future accommodation for beneficiaries. It would then be important to consider the ages of the beneficiaries and the investment time horizon when determining appropriate investments, as well as any limitations in relation to investments made.

There is generally a provision within the trust deed for amendments. However, any major amendments to the trust deed (eg adding or removing beneficiaries, new purpose of the trust, changes in the rights of trustees, etc) may trigger a resettlement which can have capital gains tax and stamp duty implications. A resettlement is a change in the essential nature and character of the original trust relationship which creates a new trust. Simply replacing a trustee with a new trustee will not generally resetttle the trust. Appropriate tax and legal advice should be obtained for changes to the trust.

Advice tip

A well drafted trust deed will reduce the risk of a trust resettlement.

Appoint a trustee and settle the trust

Determining who will be appointed as trustee should be carefully considered, including whether there will be individual trustees or a corporate trustee. As trustees are responsible for managing the assets of the trust and determining income distribution to beneficiaries, they must have a clear understanding of what the client is hoping to achieve.

The settlor pays a nominal amount to the trustee, which is generally deposited into the trust's bank account, for the purpose of establishing the trust. After this, the settlor has no further involvement in the trust.

Advice tip

Care should be taken when appointing a trustee or appointor, where the individual involved is or is expected to become an income support recipient. For Centrelink / DVA purposes, attribution of trust assets and income may be made to the person deemed to be in 'control' of the trust or is the source of trust assets. For example, where a client transfers assets to a trust, where the client is appointor and beneficiaries are the client and family members, trust assets and income Centrelink / DVA will attribute trust assets and income to the client.

Where an individual gifts an asset to the trust, there is no right of recourse to those assets. The asset becomes trust property. When gifting, a client should consider that their personal wealth reduces which may impact their future credit rating and borrowing capacity.

Where an individual loans money to the trust (or subscribes units for a unit trust), that interest is not protected and may be available to a bankruptcy trustee. However, a loan provides more flexibility than a gift as the individual can access those funds, if required, in the future.

The transfer of assets to the trust may have capital gains tax and stamp duty implications. The client should refer to their tax adviser for further guidance.

TFN, ABN, GST and business name

A trust must have a Tax File Number (TFN). The trust will also apply for an Australian Business Number (ABN) and may need to register for Goods and Services Tax (GST) if it carries on a business. Where there is no ABN, any payment to the trust must have tax withheld at the top marginal tax rate by the payer. A business name may also be registered. A bank account in the name of the trustee for the trust must be maintained.

When the account is established, the trust's TFN may be provided to the bank to ensure non-TFN withholding tax will not apply to any payments.

Types of trusts

Discretionary trusts

The trustee of a discretionary trust has the power to decide how income and capital is distributed to the beneficiaries, in accordance with the trust deed. Family trusts are generally set up as discretionary trusts.

The trustee may be able to stream certain types of income to certain beneficiaries, to provide a more efficient outcome from a tax perspective. To enable this to occur³ (rather than for all income to be proportionately streamed to beneficiaries based on present entitlement to trust income) certain conditions must be met, which may include the trust deed:

- allowing a trustee to stream capital gains
- providing the trustee absolute discretion to distribute as they see fit, or
- allowing certain types of income to be distributed across beneficiaries or streamed to a particular beneficiary.

Special rules apply in respect of capital gains realised within the trust. See 'Taxation of trusts' below.

Fixed trusts

The beneficiaries of a fixed trust generally have a fixed entitlement to the income and assets of the trust in accordance with the number of trust units that they own. For example, a unit holder beneficiary holds 1,000 units. Any distributions of income and capital gains from the trust reflect the 1,000 unit holding. The trustee has no discretion to vary distributions among unit holders. A common example of a fixed trust is a unit trust.

Hybrid trusts

A hybrid trust is a cross between a discretionary trust and a fixed trust. There are various types of hybrid trusts, for example, a hybrid trust may have fixed income units and discretionary capital distributions.

Bare trusts

A bare trust arises where the trustee simply holds an asset on behalf of the beneficiary. The only obligation of the trustee is to convey trust assets to beneficiaries when instructed. These trusts are commonly used in the following situations:

- a legal guardian invests money on behalf of a minor
- a limited recourse borrowing arrangement is used within a self-managed superannuation fund
- to hold insurance policies for a buy/sell business succession plan.

Why establish a discretionary trust?

A discretionary trust (including a discretionary testamentary trust) could suit clients who have (or expect to have) substantial assets other than their principal home or superannuation interests and want to arrange effective tax planning and asset protection. These may be useful where a client has a blended family or minor children.

³ [Tax Laws Amendment \(Measures No. 5\) Act 2011, TR 92/13](#)

Asset protection

One of the most compelling reasons to consider a discretionary trust is for asset protection such as in the event of:

- relationship breakdown
- bankruptcy
- death
- a spendthrift beneficiary or a beneficiary who otherwise lacks capacity
- a professional who wishes to limit liability in the event of a negligence claim, or
- relationship breakdown.

A discretionary trust may provide asset protection in the event of a relationship breakdown. Holding assets in a trust may ensure that assets remain within the family group. However, family law allows the court to look through trusts. In its decision, the court may consider whether one of the spouses controls a trust and can benefit from it. The court has the power under Part VIIIAA of the Family Law Act to make orders binding on third parties such as trustees.

Specialist legal advice is needed to ensure asset protection. Binding Financial Agreements (including 'pre-nuptial agreements') may be considered to provide additional protection.

Bankruptcy

Trust assets may be protected from claims by creditors if a beneficiary becomes bankrupt and has no control over trust distributions. However, an unpaid present entitlement, which arises when distributions are notionally made to (and taxed in the hands of) a beneficiary and the money is retained in the trust, are not protected.

In some cases, transactions transferring assets to a trust can be voided and the asset becomes available to creditors where:

- the asset was transferred to the trust with the intention of defeating creditors⁴
- within the period 5 years before bankruptcy, an asset was transferred to the trust for no or less than market value consideration⁵.

Income from a trust is not protected, although the trustees may choose not to distribute income to beneficiaries who are (or have potential to become) bankrupt or limit distributions to such people. Above certain income thresholds, a bankrupt is required to contribute 50% of their income to creditors. These thresholds are indexed and available on the Australian Financial Security Authority website.

Control 'beyond the grave'

The establishment of a testamentary trust upon death is generally 'hard coded' into a Will. Alternatively, the executor of the estate may have the discretion to consider the appropriateness of a testamentary trust based on circumstances at the time of the testator's death. The Will and deed may prescribe when beneficiaries become entitled to trust income and capital, or the trustee may be granted discretion to make these decisions.

Beneficiaries may not necessarily be entitled to receive income/assets of the trust upon reaching the age of 18. Access can be deferred under the trust deed. This differs from an informal trust, where a parent or legal personal representative holds assets 'as trustee for' a child beneficiary. In this case, the child becomes legally entitled to the assets upon reaching the age of 18.

A trust can be tailored to ensure that the principal's assets stay with their family or their direct descendants, subject to any state or territory rule about the maximum term of a trust.

⁴ [Bankruptcy Act 1966 – Section 121](#)

⁵ [Bankruptcy Act 1966 – Section 120](#)

Spendthrift or beneficiary without legal capacity

Where a beneficiary does not have legal capacity or has certain challenges such as substance or gambling addiction or is a spendthrift, it may not be suitable for the beneficiary to directly manage their assets. An existing trust or testamentary trust can be a useful estate planning tool to ensure that the assets are protected and properly managed.

Both the trust deed and the Will must be appropriately drafted to achieve the desired outcomes. This can include, noting specific milestones at which a beneficiary may be entitled to access capital, such as attainment of a certain age or for the purchase of a home. Choosing the appropriate trustee is important. The person should have the capacity, ability and willingness to act as trustee.

Tax planning and management

A discretionary trust allows for the splitting of income generated by the trust's assets between the beneficiaries each year. Many trust deeds enable the trustee to stream different categories of trust income. For example, franking credits may be more valuable to Australian residents who can use the franking credits. Trust income may be distributed to beneficiaries on lower marginal rates. A company beneficiary pays tax at up to 30% and this may compare favourably to other higher income earning beneficiaries. Strategic tax advice can support a tax effective outcome.

Advice tip

The trustees should seek professional advice (eg legal, accounting and/or financial planning) to ensure all potential outcomes and implications are considered. When deciding whether a trust is appropriate, consider whether the benefits outweigh the increased complexity and associated costs.

Types of discretionary trusts

Discretionary family trusts

For a discretionary trust to be considered a 'family trust' and receive certain tax concessions, the trustee must complete a 'family trust election' (FTE), which limits the beneficiaries to eligible family members (family group).

Family trust election

The FTE nominates an individual, known as the test individual (generally the client or spouse), whose family group is considered in relation to the FTE. The family group can include:

- the members of the specified individual's **family**
- former members of the specified individual's family who are no longer members due to a breakdown in a marriage or relationship, or death (including former spouses, former widows/widowers and former stepchildren)
- family controlled or owned trusts, companies or partnerships
- the family trust for which the family trust election has been made
- other family trusts with the same individual specified in their FTE
- trusts, companies or partnerships that have made an interposed entity election (see below) to become a member of the specified individual's family group
- trusts, companies or partnerships (other than non-fixed trusts) where certain members of the family group have fixed entitlements directly or indirectly, and for their own benefit, to all of the income and capital of the trust, company or partnership
- deductible gift recipients in Australia
- bodies all of whose income is exempt from income tax.

The client's tax adviser should be consulted when completing the FTE. The test individual can only be varied once subject to certain conditions. In addition to making an FTE, specific provisions need to be included in the trust deed that provide the trustees with their discretionary powers when distributing income and capital from the trust.

Tax concessions

A trustee of a family trust makes a FTE are to ensure the concessional tax treatment for the trust such as:

- franking credits can be passed to beneficiaries and
- that tax losses can be carried forward within the trust.

Whilst a trust is not a separate legal entity, it is a separate accounting entity and the trustee must file a trust tax return. Any distributions outside the family group by the trust are subject to family trust distribution tax which is at the top marginal tax rate plus the Medicare levy.

Losses

A trust cannot distribute tax losses (ie where allowable deductions exceed assessable income). However, it can generally carry forward tax losses to the future financial year. For example, if a trust had assessable income of \$20,000 and allowable tax deductions of \$30,000, a tax loss of \$10,000 cannot be distributed to beneficiaries, but it is carried forward to future years.

Similarly, capital losses cannot be distributed by a trust, but can be carried forward to offset future capital gains.

Borrowing to invest

If permitted by the trust deed, a trust can borrow to invest in an income producing asset and claim a tax deduction for interest expenses, but as noted above, it cannot distribute losses to beneficiaries.

A beneficiary can generally claim a tax deduction on borrowed amounts to purchase units in a unit trust (if the intention is to produce assessable income). Generally, a beneficiary cannot claim a tax deduction for interest on borrowed amounts which are invested in a discretionary trust.

The home

The family home may be held in the trust for asset protection purposes; however, the main residence capital gains tax exemption is not available when it is sold⁶. An exception is where the home is held by a special disability trust.

Other factors to consider include any stamp duty on the transfer and land tax on the value of the property contained within the trust.

Testamentary trusts

A testamentary trust can be an effective estate planning tool, providing asset protection, flexibility and the tax effective distribution of wealth. A provision for a testamentary trust can be contained in the Will and is activated following the will maker's death.

The Will may require the establishment of the trust, or the executor may have the discretion to determine whether to establish the trust, based on the circumstances at the time of death. It is important to have an estate planning lawyer draft the Will to ensure the testamentary trust achieves the client's goals. The trust can only be established with the net assets of a deceased estate after taxes and liabilities have been paid by the executor. Transferring the estate assets into the testamentary trust does not trigger capital gains tax.

Consideration may be given to having more than one testamentary trust where there are multiple beneficiaries. This allows the executor and/or trustees to deal with the entitlements of beneficiaries in different ways and is common where a testator has more than one adult child, with each having their own family or spouse. Conversely, it is also quite common for estate proceeds to be paid into an existing testamentary trust on the death of a second parent, so that a family with three adult children, for example, will not end up with six trusts between them.

⁶ **TD58**

The client may consider granting the executor the discretion to decide whether a testamentary trust should be established in certain circumstances such as if:

- the net amount of assets remaining in the estate after payment of liabilities and taxes is at a level that makes running the trust cost inefficient
- if the value of estate assets has diminished since writing the Will
- the estate was contested and has minimal assets remaining, or
- the beneficiary's circumstances have changed since the Will was made and a trust is no longer necessary.

To be treated as a family trust for tax purposes, the executor and/or trustees of the testamentary trust must complete a **'family trust election'** assuming the beneficiaries are eligible family members.

Most testamentary trusts are discretionary, which allows the trustee flexibility in distributing trust income and capital to beneficiaries. Alternatively, a testamentary trust can provide beneficiaries with a fixed entitlements to trust income or capital or a combination of both. Fixed trusts are not commonly used unless there is an intention to set up a 'special purpose' trust, like a superannuation proceeds trust or special disability trust (see below).

The Will (and trust deed) might specify that certain beneficiaries (often the spouse of a second or subsequent marriage, or a dependant adult child) are to have either an income interest only or a life interest in a particular trust property. This may be either for a specified period or for the duration of that person's natural life. For example, the terms of the Will and trust might specify that:

- a surviving spouse receive income distributions from the trust periodically, for the rest of their life
- the surviving spouse be granted a life interest in the family home (as trust property) until they enter aged care or pass away⁷, or
- an adult child has a life interest in the property for a certain period, after which the property is sold, with proceeds paid to other beneficiaries.

There may be provisions such that the trust vests upon the death of the surviving spouse or other dependant beneficiary. Any residual interests may be distributed to other trust beneficiaries or by the executor of the estate according to the original Will.

The use of testamentary trusts can generate tax savings, particularly if there are a significant number of children or grandchildren in the family as minors who are beneficiaries of a testamentary trust pay tax on trust income at normal marginal tax rates, this means they have the \$18,200 tax free threshold and may be entitled to the low income tax offset.

Advice tip

Take the opportunity to discuss the benefits of a testamentary trust with your clients. Also consider a second advice opportunity, to discuss how their parents could use a testamentary trust to effectively transfer wealth to their children and grandchildren.

Superannuation death benefits and insurance proceeds paid into the estate can be directed into a testamentary trust via the Will. The legal personal representative ('estate') should be nominated as the beneficiary.

Testamentary trusts have the following disadvantages:

- the estate may be delayed until grant of probate is completed, which delays the establishment of the trust
- the estate may be contested, so the trust may have reduced assets available for beneficiaries
- higher legal costs for establishing a testamentary trust in the will and ongoing costs for tax advice and accountant's fees.

⁷ Consider whose responsibility it is to maintain the property and to pay any ongoing expenses, such as rates, strata levies, insurance premiums and maintenance costs.

Super proceeds and testamentary trusts

If a super death benefit is paid to the estate and moved to a testamentary trust, the tax payable by the executor or administrator of the deceased estate on the death benefit depends on whether all the potential beneficiaries of the trust are dependants for tax purposes⁸. Once paid out from super, the money loses its superannuation identity and is treated as ordinary money.

If **all** beneficiaries are tax dependants, no tax is paid, as would have been the case if paid by the super fund directly to the beneficiary.

If **any** of the beneficiaries of the trust are non-tax dependants, tax may be payable on the taxable component of the super proceeds as if the benefit was paid to a non-tax dependant.

Advice tip

Where a testamentary trust will have both dependent and non-dependent beneficiaries, consider incorporating provisions for a 'sub-trust' to isolate super proceeds for the benefit of tax dependant beneficiaries. This may assist in ensuring a more favourable tax outcome. Consult a qualified legal practitioner and registered tax agent to establish this arrangement.

Child maintenance trusts

A child maintenance trust may be established to provide for the ongoing maintenance of a child/ren after a relationship breakdown (married or de facto). A child maintenance trust is usually established and controlled by the non-custodial parent to hold assets for the benefit of the child/ren and trust income is used for their maintenance. The intention of the trust is to tax effectively reduce the amount of income needed to pay child support obligations. Important considerations include:

- When the trust ends, the assets of the trust transfer to the children (age 18 or later).
- Depending on the assets transferred into the trust, capital gains tax and stamp duty may apply to the parent transferring the assets.
- May provide significant tax savings for high income earning parents by shifting the tax liability on the income from the asset from the parent to the child. The income qualifies as excepted income for the child and is taxed at adult marginal tax rates.
- The establishment of the trust would have to be part of the property settlement.
- Benefits of the trust may increase with longer child support periods.

Tax savings created by the trust must be balanced against the costs incurred to establish and maintain the trust and the foregoing of assets as trust assets must vest in the child.

Example 1 – Child support

If child support is \$15,000 pa, a taxpayer on a 39% marginal tax rate (includes Medicare levy) requires approximately \$24,590 ($\$15,000 / (1 - 0.39)$) in gross income to meet this expense ($\$24,590 - \$9,590 \text{ (tax)} = \$15,000$). In comparison, a child maintenance trust only needs to generate \$15,000 in gross income to be distributed to the child. The distribution will be included in the child's assessable income and assuming the child has no other income, can be received tax free.

Specific tax and legal advice should be obtained by clients considering a child maintenance trust.

Special disability trusts

A special disability trust is generally established by immediate family members to provide for the care and accommodation costs of a person with a severe disability. Where established and maintained under social security legislation, taxation and social security concessions apply.

⁸ ITAA 97 s302-195

The special disability trust must:

- have only one principal beneficiary (ie the person for whom the trust is established) who is severely disabled, whose level of impairment would generally qualify for disability support pension
- have a trust deed that contains the clauses set out in the model trust deed (or be issued with a waiver notice for excluded requirements)
- have an independent trustee or more than one trustee
- primarily provide only for the reasonable accommodation and care needs of the principal beneficiary
- comply with investment restrictions
- provide annual financial statements and a statutory declaration to Centrelink or DVA
- conduct independent audits when required.

The advantages of a special disability trust include:

- up to \$813,250 (2024/2025 financial year, indexed annually) of all assessable assets within a special disability trust are exempt from the assets test
- the principal residence held within the special disability trust is exempt from the assets test, and
- all the trust income is exempt under the income test.

Immediate family members of age pension or service pension age who are receiving a social security pension (eg Age, Disability, Carer Payment) are eligible to collectively gift up to \$500,000 of assets to the special disability trust without deprivation rules applying. Immediate family members include natural parents, legal guardians, adoptive parents, stepparents, grandparents and siblings.

From a tax perspective, the net income of the trust is included in the primary beneficiary's assessable income and taxed at their marginal tax rate even where income is not distributed. If the primary beneficiary of a special disability trust is an excepted person, trust income is taxed at ordinary adult tax rates apply (not the penalty tax rates that would otherwise apply to minors).

The following capital gains tax (CGT) concessions apply:

- Any capital gain or loss is disregarded where a CGT asset is transferred into an SDT for no consideration⁹. The trust's cost base is the asset's market value at the time of transfer.
- The main residence exemption is available for property, that is, as the principal beneficiary's principal home if it is owned by an SDT.

However certain features of special disability trusts that must also be considered.

The principal beneficiary and their partner cannot gift to the trust unless the contribution is funded by a bequest or superannuation death benefit within three years of the event.

Trust income and capital can only be spent for the care and accommodation of the principal beneficiary. A certain amount for the benefit of the beneficiary that is not directly related to their care and accommodation needs, without risking the concessional assessment of the trust is limited to \$14,000 (2023/24).

The principal beneficiary is the sole beneficiary of the trust while it is a special disability trust. Family members can only receive trust assets when the principal beneficiary passes away and they are remainder beneficiaries. Trust assets cannot be used to pay family members for any services provided to the principal beneficiary.

If the trust is wound up (due to death or non-compliance) and immediate family members do not receive the portion of the assets reflecting their contributions to the trust, deprivation may apply to that immediate family member if they transferred assets to the trust within the last 5 years.

⁹ ITAA 97 s118-85

Advice tip

If a family has a person with a severe disability, a special disability trust could be used to improve the social security position of the disabled individual and/or immediate family members that can contribute to the trust. Any potential benefits (including tax) should be weighed against the costs of establishing and maintaining the trust, trustee and reporting requirements, and inaccessibility to trust assets and income by family members until the trust is wound up.

Taxation of trusts

A trust is treated as a separate entity for tax purposes¹⁰. A trust must lodge annual tax returns. Managing the tax affairs of the trust is the responsibility of the trustee.

A trust is a flow through vehicle whereby the beneficiaries of the trust may be taxed on distributions to which they have 'present entitlement.' All the taxable income (assessable income less allowable deductions) of the trust must be distributed as per the trust deed, otherwise any retained income is taxed at the top marginal tax rate plus Medicare levy (exceptions apply).

Income distributed through a trust ordinarily retains its character. Interest, rent, dividends, capital gains etc are treated as if these are received by the beneficiary themselves.

For example, a capital gain realised by the trustee and distributed to a beneficiary is assessed as a capital gain in the hands of the beneficiary. Beneficiaries of a trust are generally required to declare trust distributions in their tax return unless they are eligible for an exemption. Trustees should provide details of the income distributions to beneficiaries to assist with their tax affairs. Trustees have withholding tax obligations where beneficiaries are minors, bankrupts, and non-residents.

Trust income distributed to non-residents

The trust must withhold tax (known as final withholding tax) at prescribed rates on certain income distributed to non-residents, such as unfranked dividends, interest. The non-resident is not required to lodge a tax return in respect of income subject to final withholding tax.

Trust income distributed to a beneficiary under a legal disability

Where trust income is distributed to a beneficiary under a legal disability (eg a minor, a bankrupt or declared legally incapable because of a mental condition), the trustee of the trust is generally taxed on the income on behalf of the beneficiary¹¹. The trust distribution must be included in the beneficiary's tax return and a credit is received for any tax paid by the trust.

Unearned income from a trust, to which a minor is presently entitled, is generally taxed at the higher rates of taxation applicable to minors¹². Consequently, distributing trust income exceeding \$416 in a financial year to minors may not be tax effective unless the minor is an 'excepted person' or the trust income is 'excepted income'. Excepted income includes income from a child maintenance trust, a special disability trust, a testamentary trust or another trust that holds capital arising from the death of an individual, such as insurance or superannuation proceeds. Excepted income or income of an excepted person is taxed at the ordinary adult tax rates (the penalty tax rates for minors do not apply).

Minors that are not excepted persons are not entitled to the low income tax offset (LITO) in respect to unearned trust income¹³.

There is more scope to distribute trust income tax effectively where a beneficiary is an excepted person or the income being distributed from the trust qualifies as excepted income.

¹⁰ ITAA97 s960-100(f)

¹¹ ITAA36, s 98 (1)

¹² ITAA36, s102AC(2) Unless the child is an 'excepted person' in which case the income is taxed at the ordinary adult rates.

¹³ ITAA97 s61-115 LITO cannot be applied by a minor against any income which is not 'excepted income' or where the minor is not an 'excepted person'.

Tax planning

The following example illustrates how trusts can be utilised for income splitting across beneficiaries.

Example 2 – Income splitting

Michael recently died and was survived by his wife Sally (whose marginal tax rate is 39%) and two young children, David and Lizzie. His estate comprises an investment portfolio worth \$500,000, which generates an income of \$20,000 pa.

If Michael left the investment portfolio to Sally directly via his Will, she would have to pay tax of \$7,800 on the income. Instead, Michael decided to make a provision in his Will so a testamentary trust can be established, with Sally and each of the children as beneficiaries. He appointed Sally as trustee and gave her discretion to distribute income.

As trustee, Sally distributes income of \$10,000 pa to each of the two children because they have no other income. David and Lizzie can receive this income without paying any tax given they can each receive tax-free income up to \$18,200 pa and the low income tax offset applies to excepted income received by minors. They may potentially receive additional income in future years in this tax-effective manner.

The table below summarises the income and tax implications of paying the money directly to Sally and using a testamentary trust. By having the foresight to establish the trust, Michael saved his family \$7,800 tax in the first year alone. In addition, Sally has the flexibility to alter the income distributions amongst the beneficiaries over time.

What	Investment paid directly to sally		Investments flow into testamentary trust	
	Income	Taxation	Income	Tax
Sally	\$20,000	\$7,800	Nil	Nil
David	Nil	Nil	\$10,000	Nil
Lizzie	Nil	Nil	\$10,000	Nil
Total	\$20,000	\$7,800	\$20,000	Nil

Unpaid present entitlements

Discretionary trusts may retain distributions that have been notionally allocated (ie a beneficiary has present entitlement but the income has not been physically distributed), until the beneficiary calls for the income to be distributed. This is called an 'unpaid present entitlement'. These amounts may be treated as loans to the trust, resulting in the creation of a 'beneficiary loan account'. These loan accounts belong to the beneficiaries who were entitled to, but did not receive, the trust distributions.

There are risks associated with the creation of beneficiary loan accounts as the beneficiary is entitled to request repayment of the loan at any time. Further, if the beneficiary is a private company, the ATO may assess the unpaid present entitlement as a 'Division 7A loan'.

In relation to testamentary trusts, it may be possible to include provisions in the beneficiary's Will stipulating that where a beneficiary loan account exists, the trustee is not required to repay the loan to a deceased beneficiary's estate (ie the debt is forgiven in the Will).

Specialist legal and tax advice should be sought to determine the most appropriate course of action in relation to unpaid present entitlements.

Anti-avoidance

The anti-avoidance provisions in Part IVA of ITAA 1936 may apply in circumstances where the dominant purpose for setting up a trust arrangement or scheme is to derive a tax benefit. Examples may include where personal services income is diverted to a discretionary trust and split to reduce the tax that would otherwise have been payable, and where distributions are made to tax-exempt beneficiaries¹⁴.

Tax advice should be sought from a registered tax agent to ensure that Part IVA does not apply.

Social security implications

The social security assessment of trust arrangements is complex. Centrelink will consider the specific circumstances of any trust arrangements of an individual who is involved in a trust.

You should ensure that there are no unforeseen consequences because of the client's involvement or interest in a trust. Generally, two tests are used when attributing the income and assets of a trust to social security recipient. These are the control test and source test.

Source test

Where assets are transferred to a trust for no consideration or inadequate consideration, the assets of the trust may be attributed to the individual under the source test. If it can be proved that individual made a genuine gift and has no ongoing involvement in the trust, deprivation rules apply. A person or couple is allowed to gift \$10,000 per financial year maximum and up to a maximum of \$30,000 in a rolling five financial year period. Any amount above these thresholds is assessed as a deprived asset for five years from the date of the gift and the amount is deemed for the income test.

Control test

The control test will determine whether an individual has formal or informal control of the trust and whether any income or asset value should be attributed to the individual. Formal control is generally held by the trustee or the person who can appoint and dismiss the trustee (ie the appointor) or someone who can veto a trustee's decision or change the trust deed. An individual who can influence the trustee to make certain decisions may also be deemed to control the trust.

In some circumstances, the trustee may be attributed with all or a portion of income and assets under the control test. While being either the appointer or trustee is a significant indication of control, other factors are considered. The amount of assets and income attributed to an individual depends on their level of control. Therefore, care should be taken when providing guidance or advice when establishing a trust to ensure that implications for all parties involved have been considered.

Example 3 – Control test

Tom and Leanne (both 43) are tragically killed in a car accident. Their Wills which provide for the establishment of a testamentary trust upon their death, with their two young children as sole beneficiaries.

Leanne's elderly mother Elsie was appointed sole trustee and appointor of the trust and she also became the legal guardian of the children. Each year, all investment earnings of the trust are distributed equally between the two minor children.

Elsie is an Age Pension recipient. Elsie reports to Centrelink that she is trustee and appointor of the testamentary trust. While Elsie controls the trust, she is not the source of the trust's funds and she is not a beneficiary. The trust assets and income are attributed to the two young children who are the sole beneficiaries of the trust¹⁵. However, this is at Centrelink's discretion based on an assessment of all circumstances.

¹⁴ ITAA 1936, s 100AA and 100 AB

¹⁵ Social Security Act 1991 s1207X

Relinquishing control

Simply relinquishing control and interest in a trust may not immediately achieve a more favourable social security outcome for a client. Centrelink generally treats the individual/s as having gifted their share of the assets of the trust at the time of relinquishing control, which is assessed under the deprivation rules. For Centrelink to accept that control has been relinquished, they consider the specific circumstances of the arrangement, including:

- whether or not formal control has been given up (by resigning as trustee or appointor), and
- whether the trust deed has been changed to remove the individual as beneficiary.

Where Centrelink determine that informal control remains, attribution may continue.

Trust owns primary residence of beneficiary

Where an individual lives in a dwelling owned by a trust and the individual has reasonable security of tenure, Centrelink assesses the individual as a homeowner. The value of the home is not assessed for means-testing purposes.¹⁶

However, the main residence CGT exemption upon disposal of the residence is not available where the home is held by a trust other than a special disability trust. Therefore, asset protection provided by holding the main residence in a trust structure should be carefully weighed against the potential CGT payable on its any future disposal (where the exemption would have otherwise applied if the dwelling was owned personally).

Trusts and super contributions

Generally, a trust can only claim a deduction for a super contribution where the person on behalf of whom the contribution is made is an employee of the trust¹⁷. The term 'employee' is taken to have its common law meaning¹⁸ and extends to any person treated as an employee under section 12 of the Superannuation Guarantee Administration Act 1992.

Where a business is being run through a trust, proving that the individual is an employee engaged in activity which generates income a business being run through the trust is more straightforward. Where the trust is simply a passive investment trust, it is more difficult to substantiate an employment arrangement exists. Directors of the corporate trustee, who fall outside the common law definition of employee¹⁹, and do not receive remuneration may not be defined as an employee for tax deduction purposes.

In some instances, super contributions on behalf of a beneficiary who is not an employee of the trust are made from available assets of a family trust. The amount will be treated having been paid to (and assessable for tax) to the beneficiary.

Advice tip

Deductibility should be approached on a case by case basis and needs to be determined by a registered tax agent. Treatment of contributions made by a trust on behalf of a client should then be confirmed by the registered tax agent to ensure financial advice provided is appropriate.

Small Business CGT Concessions

A discretionary trust may be eligible for the available Small Business CGT concessions when disposing of a small business asset. Where the 15-year exemption or retirement exemption applies, concession stakeholders of the trust may then be able to receive distributions from the trust, and may make CGT cap contributions to superannuation, subject to the Lifetime CGT cap. The retirement exemption has a \$500,000 cap.

¹⁶ Guide to Social Security Law [4.12.3.40](#)

¹⁷ ITAA 97 s290.60

¹⁸ [TR 2010/1 p234 and p243](#)

¹⁹ [TR 2010/1, p238, Kelly v FCT \[2013\] FCAFC 88](#)

Discretionary trust distributions to SMSFs

Income derived by a super trustee as beneficiary of a discretionary trust is treated as 'non-arm's length income' and is subject to tax at the top marginal tax rate. This applies without exception²⁰. Accordingly, trustees of discretionary trusts should not distribute income to SMSFs.

Key advice issues and considerations

Who provides advice on what?

In identifying a potential need for a discretionary trust, establishing the trust and trust deed, investment advice, and ongoing administration of and making distributions from the trust, qualified professionals need to be involved.

Legal professionals

The trust should be established with advice and guidance of an experienced legal professional. A trust deed is a legal document and the way in which the deed is drafted may be crucial in mitigating the chance of any successful future legal disputes.

Registered tax agent

The trustee is responsible for completing and submitting tax returns on behalf of the trust and may make decisions regarding distributions to achieve a tax effective outcome. A registered tax agent should be engaged when the trust is established and on an ongoing basis so the trustee understands the tax implications of any trust distributions they make.

Financial adviser

A professional adviser may identify the potential benefits of establishing a discretionary trust or making provisions for a testamentary trust in the client's Will. While specific legal and taxation issues should be addressed by the solicitor and registered tax agent, the financial adviser should understand any guidance or advice the client receives from other professionals.

Advice tip

The financial adviser should attend joint appointments with the solicitor and tax adviser. Solicitors and tax advisers may not fully understand the rules that relate to financial planning areas, such as superannuation, social security and aged care. Therefore, it is important to review the proposal to consider any potentially adverse implications before finalising the structure and trust deed and appointing trustees and beneficiaries.

Where ongoing advice is provided to the trustees about the trust's investments and assets, those recommendations must be consistent with any specific guidelines and restrictions set out in the trust deed. Further, it is important to consider the objectives of the trust to ensure that recommended investments are appropriate and align to those objectives.

²⁰ ITAA 97 s295-550(4)

Appendix A – Glossary

Term	Meaning
Beneficial ownership	<i>Beneficial ownership</i> belongs to the person who has the right to benefit from or enjoy property, or income. However, the legal ownership of the property or asset may rest with another person. In the case of a discretionary trust, the trustee/s of the trust is the legal owner/s of trust assets and the <i>beneficial ownership</i> rests with the beneficiaries.
Fiduciary relationship	A <i>fiduciary relationship</i> exists where one party has a legal or ethical relationship of trust with another. The fiduciary must act in the best interest of the other party and put their interests above their own.
Trust deed	<p>A <i>trust deed</i> is a legal document that sets out the purpose of holding assets in trust for beneficiaries. The deed identifies the trustees and beneficiaries and their rights and obligations. It should also set out the governing rules of the trust and the way benefits are to be paid to beneficiaries.</p> <p>The <i>trust deed</i> should give direction to the trustees depending on its purpose and appropriate legal and tax advice should be sort in drawing up the deed.</p>
Present entitlement	<p>Broadly, a beneficiary has a <i>present entitlement</i> where they have the legal right to demand payment from the trustee.</p> <p>A beneficiary may become presently entitled to trust income in situations, including where:</p> <ul style="list-style-type: none"> ▪ the trust deed specifies a present entitlement occurs in certain circumstances (and those circumstances arise), and ▪ the trustee exercises their discretion. <p><i>Present entitlement</i> may exist before the actual payment has been received.</p>
Vesting	When the trust reaches the end of its term, the legal ownership of the trust assets passes to the beneficiaries. It is also possible that only some assets of the trust will be vested to one or more beneficiaries during the life of the trust, either at the trustees' discretion or through the terms of the trust.

Appendix B: State and Territory trustee legislation

State or Territory	Legislation
Australian Capital Territory	Trustee Act 1925
New South Wales	Trustee Act 1925
Northern Territory	Trustee Act 1893
Queensland	Trusts Act 1973
South Australia	Trustee Act 1936
Tasmania	Trustee Act 1898
Western Australia	Trustees Act 1962

Contact details

For further information, please contact TechConnect on 1800 645 597

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