THE ADEPT INVESTOR

eBook Series

Discretionary Family Trusts:

The 7 Factors that All Property Investors Must Consider before using a Discretionary Family Trust for Investment

This Issue:

Is a Discretionary Family Trust the best entity for your property investment portfolio?
The wrong decision can cost you tens of thousands of dollars.
What are the seven most important factors to consider before you make a decision?

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Before you start

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Before acting on any information contained herein you should consider if it is suitable for you.

You should also consider consulting a suitably qualified financial, tax and/or legal adviser.

The information in this document is not a substitute for professional financial and legal advice.

We encourage you to seek professional financial advice before making any investment or financial decisions.

In any circumstance, before investing you should consider whether it is appropriate for your objectives, situation and needs.

Introduction

Many people ask me if they should purchase an investment property within their own name / joint names or within a Discretionary "Family" Trust.

In short there is no right or wrong answer, the best entity to use will be dependent on your property investment strategy and personal circumstances.

No matter what you decide, it's important that you make an informed decision, because if you don't, it can cost you thousands of dollars.

In this issue of the Adept Investor I will give you a broad overview of what a Discretionary Family Trust is and how it works. More importantly I will highlight the details that many property investors don't consider before they set up and purchase properties within a Discretionary Family Trust.

Trusts a General Overview

A Trust is basically a legal structure whereby a person or company (the Trustee) holds assets on trust for the benefit of a group of beneficiaries. The Trust will have an ABN, tax file number (TFN), and if the turnover is greater than $75,000 a year, may be also required to be registered for GST.

What is a Discretionary Family Trust?

A Discretionary Family Trust refers to a discretionary trust which is created to hold the assets belonging to a family and can be used to conduct a family business which allows the profits to be distributed among the family members (beneficiaries) for the benefit of those family members. The word “discretionary” refers to the power or *discretion* the Trustee has to decide which beneficiary or beneficiaries receive the net income and capital from the trust each year. The distribution is at the discretion of the trustee and can differ each year.

Such trusts are commonly set up in order to:

- Distribute investment income,
- Apply tax benefits, and or
- Asset protection.

How a Discretionary Family Trust Works

To see how this works and why most people are initially attracted to Discretionary Family Trust let’s look at how they work. For this example, we have the Smith Family, Mum, Dad, a son who is looking for work and a daughter who is at university with a part time job.

Tax Benefit

At the end of the financial year the Smith Family Trust has a gross profit of $28,000. Any income distributed by the trust to the family members (beneficiaries) will be treated as taxable income when those family members complete their personal tax return.

As this is a discretionary trust, the Trustee (Mrs Smith) has looked at two options, A & B. Mrs Smith chooses to take advantage of the tax-free thresholds of the children and distributes the profit to the children (option B) rather than to her and her husband who would be liable to pay tax on the $28,000.

Beneficiaries	Annual income	Tax Rate	Distribution Option A	Tax on Option A	Distribution Option B	Tax on Option B
Dad	$60,000	32.5%	$14,000	$4,550		
Mum	$80,000	37.0%	$14,000	$5,180		
Son	$0	0.0%			$18,000	$0
Daughter	$8,000	0.0%			$10,000	$0

Note this type of distribution may affect Centrelink / DVA and other Govt payments for beneficiaries as it is generally recorded as income.

Asset Protection

Another popular reason investors purchase properties within a Discretionary Family Trust is to protect the assets from future creditors. In most cases, from an asset protection perspective, assets held in a family trust cannot be attacked by creditors or lawsuits so they are ideal for protecting assets from business or personal disputes particularly where there is a high chance of a family member being sued.

WARNING - Australian Tax Office (ATO) Targeting Tax Avoidance via Family Trusts

This year the ATO announced that it is conducting a pilot program to determine whether trusts are complying with tough anti-avoidance rules when they distribute income to tax exempt beneficiaries. This comes after the creation of the Trust Task Force that was created by the ATO in 2014 which over the first 30 months of operation, has raised $652 million in liabilities and collected $114.4 million.

The ATO will be reviewing trusts' compliance with sections 100AA and 100AB of the Income Tax Assessment Act 1936 along with anti-avoidance rules which are designed to prevent trustees using tax-exempt entities to shelter the trust's net income.

Some of the Family Trust arrangements which attract the Task Force's attention are*:

- Trusts or their beneficiaries who have received income are not registered, or have not lodged tax returns or activity statements;
- Distributions which have not been paid to the beneficiary (not just on paper)
- Beneficiaries not being registered in the trust deed;
- There are artificial adjustments to trust income, so that tax outcomes do not reflect the economic substance – for example, where parties receive substantial benefits from a trust while the tax liabilities corresponding to the benefit are attributed elsewhere or where the full tax liability is passed to entities without any capacity or intention to pay; and
- changes have been made to trust deeds or other constituent documents to achieve a tax planning benefit, with such changes not credibly explicable for other reasons.

*Source ATO Trust Taskforce website https://www.ato.gov.au/general/trusts/in-detail/compliance/trusts-taskforce/

Why a Legitimate Family Trust may be classified as an Avoidance Scheme by the ATO

> *Investors need to remember that if any entity which is created for the purpose of Tax Avoidance (or minimisation), even if it is a legitimate entity, can be deemed by the ATO as Tax Avoidance Scheme if you "inappropriately move funds through several entities to avoid or minimise tax that would otherwise be payable" ATO Tax Avoidance Fact Sheet*

Let's look at the Smith family from our example of how a Family Discretionary Trust works and compare what the ATO may view as appropriate or tax avoidance.

✓ Mrs Smith used option B and distributed the $28,000 profit to her children as they were both under the tax free threshold and as a result saved over $9,000 in tax. The children are:

  - ✓ Beneficiaries of the trust,
  - ✓ Distribution has been actually paid to the children, and
  - ✓ The distribution has been reported on the Trusts and children's Tax returns.

x If after doing all of the above the children then transfer the funds back to their parents or if the funds are used by the parents, ie home or car loan in the parents name, parents are a trustee or joint account holder of the children's bank account and access funds, then this may be viewed by the ATO as a tax avoidance scheme because the distribution was simply funnelled through the children to avoid or minimise tax and used by the parents.

The 7 Factors that All Property Investors Must Consider before using a Family Trust

There are a number of issues to consider before making a decision about whether or not a Discretionary Family Trust is the best entity under which to purchase property. In any case you should consult a qualified, accountant, financial planner and in some cases a legal practitioner to explore all options, and at the very least do a cost benefit analysis and make an informed decision based on your personal circumstances and investment strategy.

Many investors I meet have jumped into utilising a Family Trust because their accountant has said it was a good idea, and in many of those cases they have regretted it. Before you make a decision you must consider the following 7 factors as a minimum.

Note: The following considerations are based on what I would call a standard Discretionary Family Trust used for property investment. Considerations are general and may be different dependant on trust set up such as hybrid trusts, where the trustee is a company and not an individual or if the trust is also used to run a family business.

#1 Costs to establish and maintain a Discretionary Family Trust

As a bare minimum, the tax advantages for the establishment of a Family Trust should cover the establishment and ongoing costs.

It should be noted that if the Trustee of your Trust is a company, then there will be additional costs and compliance requirements to those listed below.

- **Establishment Costs.** The cost of establishing a typical Family Trust can be between $1,000 to $2,000 dollars depending who sets it up for you. As part of the establishment of the trust you will have to apply for an ABN and TFN.

- **Holding Costs.** Maintaining the Family Trust may cost you between $1,500 to $2,500 a year in accounting and governance fees including the lodgement of annual tax return and filing fees.

#2 Lending within a Trust

Lending is crucial for most property investors from a position of borrowing capacity and cash-flow and most lenders view loans to trusts different to individual/joint property owners.

- **Loan guarantor**. It is important to note that most lenders which do lend to Trusts will require that the loan and property title are in the trusts name, while the Trustees will be required to guarantee the loan. This will have a potential impact on tax deductions, which I will discuss latter, in addition to asset protection. Remember if you personally guarantee the loan, and the trust can't make its re payments then the bank can come after you and your assets.

- **Access to lenders**. Approximately 50% of Australian lenders don't lend to Trusts for the purchase of investment properties, reducing your choice of lenders.

- **Higher interest rates.** Most lenders that do lend to Trusts, do so through their business banking departments ie WESTPAC. In these circumstances even though you are purchasing an investment property you will probably be charged business loan rates which are generally between .5% to 1.5% greater than the banks personal variable loan rates for property.

	WESTPAC Loan Comparison	
	Individual / Joint	Family Trust
Loan Amount	$450,000	$450,000
Interest Rate	4.71%	5.26%
Interest - Annual	$21,195	$23,670

- **Borrowing capacity.** Borrowing within a Trust may also reduce your borrowing capacity due to:

    - Calculating serviceability of the loan the lender will consider the financials of the Trustees and calculate lending based on the increased interest rates which reduces the amount you can potentially borrow ie interest costs are greater so borrowing capacity is less.

    - The term of the loan will normally be up to 25 yrs for a loan within a Trust compared to up to 30 yrs in personal names. The reduced term increases the projected principle & interest payments per month (because the loan has to be paid off sooner) which will reduce your borrowing capacity.

- **Increased loan costs**. Many lenders will charge you additional establishment fees for loans within a Trust. This is because they will charge you the cost for their due diligence ie having the trust deeds reviewed by their solicitors which could be an additional $800 to $1,500 dependent on the lender.

#3 Capital Gains Tax

- **No PPoR exemption.** If the home you live in is owned by the Discretionary Family Trust then you will generally **not** be able to claim the Primary Place of Residency (PPOR) exemption for capital gains tax when you sell the property**.

  This is because you don't own the property, the Trust does and as a result you do not qualify for the exemption.

  This will potentially have a significant impact if you currently live in the property or if at some stage you may live in one of your investment properties and try to claim a partial exemption.

  ***Source: ATO Interpretative Decision, ATO ID 2003/467.*

- **Capital losses.** If the trust sells an investment property at a loss, then the loss is generally trapped within the trust. You **will not** be able to offset the capital loss against any personal loss from a tax perspective. The loss will remain within the trust until you can offset it against a Trust capital gain.

- **Capital gains.** Trusts, unlike companies, can claim the 50% discount when distributing a capital gain. If a beneficiary is made specifically entitled to a trust capital gain, the capital gain is taken into account in working out their net capital gain for the income year with the benefit of any discounts or concessions they are entitled.

  Streaming capital gains can be extremely complex and expert qualified advice is required to ensure that you meet all compliance & trust deed requirements.

#4 Losses and Deductions Trapped within the Trust

As a general rule, all losses are trapped within the fund and cannot be claimed against your personal income.

Property in Trust - $500,000 property / $450,000 loan	
Expenses	
Rates	$1,800
Property Management at 7.5%	$1,755
Water / Sewage	$800
Loan interest @5.26%	$23,670
Maintenance	$500
Letting fee (1 weeks rent)	$450
Total Cash Expenses	**$28,975**
Total Rent @ $450 pw	**$22,500**
Loss	**$6,475**

In this example we can see a realistic example of an investment property with expenses and rent within a trust. A $500,000 property, a $450,000 loan with a rental yield of 4.69%. The property makes a loss of $6,475 before we even consider depreciation.

The loss would still need to be met by the trust to cover all cost, because you can't not pay the loan, which means the trustee would need to find the money to meet the loss and pay for all expenses either through a gift or loan to the trust.

- **No negative gearing against personal income.** Any loss the Trust makes generally cannot be claimed against a trustee's or beneficiary's personal income and thus can't be used to reduce your personal taxable income and increase your tax return.

  The loss can only be claimed against other profits or future profits made by the Trust ie if another property or business within the Trust has made a profit.

- **Loan Interest.** Many people make the mistake of claiming the loan interest as a deduction against their personal tax returns, remember if the loan is held in the trusts name and you are simply a guarantor, then generally speaking you cannot claim the interest as a personal deduction.

- **Depreciation.** Depreciation is a paper deduction, meaning it's an expense you can claim without having paid for it, however, like other deductions you can only claim the depreciation within the Trust not against your personal income as the Trust owns the property.

#5 Land Tax the Additional Expense

In most states, properties purchased within a Discretionary Family Trust will attract additional expenses due to lower or in some cases no land tax threshold for those properties.

Land tax is a state tax and different states have different regulations in regards to how the tax is calculated, exemptions for own home and assessable land tax thresholds. Investors and trustees should consult the various state authorities to determine any land tax liability based on property in particular states and territories.

- ❖ **Own Home Exemption.** As a general rule your own home in which you live in is usually exempt from land tax under the own home exemption. However if the home is owned by a Discretionary Family Trust, in some states you may lose your exemption and be required to pay land tax, for example:

  - In Qld, a home exemption is available in respect of land owned by a trustee, other than an absentee, and used as the home of all the beneficiaries of the trust. Which means to claim the exemption **all** the beneficiaries of the trust must reside in the home.
  - While in NSW, a Discretionary Family Trust is deemed to be a "Special Trust" and as such any property owned by a Special Trust cannot receive a principle place of residence tax exemption.

- ❖ **Land Tax Thresholds**. Many states have different land tax thresholds before owners are subject to the payment of land tax. The table below displays the thresholds for the three most popular investing states and the difference between personal ownership and ownership within a Discretionary Family Trust. In regards to the personal ownership levels it should be noted that it is per person, so if a couple own all their investment properties in joint names in Qld, then their total land taxable value would have to be over $1.2 million before they are subject to land tax ($600,000 threshold each).

Land Tax Thresholds			
	Qld	**NSW**	**Vic**
Personal Ownership	$600,000	$482,000	$250,000
Discretionary Family Trust	$350,000	0	$25,000

Let's look at an example of what the annual land tax liability may be for a couple who have their own home + two investment properties in NSW either in their own name or within a Discretionary Family Trust.

Property	**Land Value**	**Annual Land Tax Liability**	
		Own Name	**Discretionary Family Trust**
Family Home	$500,000	Exempt	$8,000
Investment x 2	$800,000	$0	$12,800
	Total	$0	$20,800

Note: the land tax rate is 1.6% of the taxable land value above the threshold in NSW & DFTs are treated as a "Special Trust".

#6 Taxation – Other Distribution Issues

There are also some other general taxation issues that you need to be aware and must discuss with a qualified accountant / financial planner if considering a Discretionary Family Trust, these include but are not limited to:

- **Undistributed income.** Undistributed income is taxed in the hands of the Trustee at the top marginal tax rate. This gives a strong incentive for Discretionary Family Trusts to fully distribute the Trust's income before the end of each financial year.

- **Distributions outside the "Family Group".** A consequence of making a family trust election outside the family is that any distributions (broadly defined) outside the family group of the Family Trust, by the Trust, will be taxed at the top marginal rate applying to individuals plus the Medicare levy.

- **Distribution to minors.** If the beneficiaries are minors, that is under 18 years of age on the 30 June, and the distribution is "unearned income", meaning income not earned from employment, then the resident tax rates for minors on unearned income (not including Medicare levy) is:
  - $0 to $416 Nil
  - $417 to $1,307 66%
  - Over $1,307 47%

- **When do Trust Distributions need to be made?**
  - **Trust Income.** If you make beneficiaries entitled to trust income for an income year by way of a resolution, it will only be effective for determining who is assessed on the trust's net (taxable) income if it is made by the end of the income year (30 June), or by the date in the trust deed if earlier.
  - **Trust Capital Gains.** If you make beneficiaries specifically entitled to trust capital gains by way of appointing trust capital to them that must be done within 2 months of the end of the income year (31 August).

#7 Asset Protection – Determining the Risk

Many investors and clients look at setting up a Discretionary Family Trust due to concerns about asset protection at being sued and their assets being sought by future creditors.

As a general rule, assets within a trust are fairly well protected, however trusts can be very complex, expensive, require ongoing compliance and registration requirements, expensive and reduce your properties cash-flow.

Many clients look at trusts for asset protection out of fear, either generated by stories, zealous accountants or even by some in the property investment industry.

My strong recommendation is to conduct a personal / professional risk analysis and determine what the actual risk and probability is for you or your business to be sued and your personal assets being placed at risk. Take a holistic view at your level of risk and put in measures to mitigate the actual risk itself.

The two main concerns that friends and clients raise with me are:

- **What if a tenant sues me?** First up let me say that I strongly recommend to all clients that you have landlord's insurance. Most policies will have up to $20 million in public liability insurance as part of the policy.

  Secondly, I personally have not come across any investor who has been sued. After a lot of research, in the cases where tenants had successfully sued a landlord, in all cases, it was an issue of landlords not repairing defects which had been reported by the tenant.

  In 1997 the High Court said:

  A landlord has a duty to its tenants to use reasonable care and skill to provide safe premises. The obligation is limited to repair of defects which the landlord was or should have been aware. The landlord must reasonably respond to any information it receives as to the existence of any defect.

  So don't be a slumlord, this is your investment so keep it in good repair and ensure that your property manager acts on damage reports promptly, especially those that affect the safety of your tenants. If your investment is kept in good repair, and repairs to defects are made in a reasonable time then the tenant would need to prove that you were negligent and ignored your responsibilities as a landlord.

  - **I own a Company, what if my company is sued or becomes bankrupt?** The ATO states" *Generally speaking, if you comply with all of your legal obligations as a director of a company, the company will be responsible for meeting the debts or other liabilities of the company, not you personally. This means debts or liabilities of the company will be paid by the company, not you as a director. However, there are some exceptions"*

    Business insurances can offer you protection from public and professional liability. The exceptions to when a company director may be liable for the company's debt may be if you trade while insolvent, owe PAYG or Superannuation to employees or provide "Personal Guarantees" to investors or banks.

Trust vs Own Name – Cost Benefit Analysis

As part of your decision process, you should sit-down with an accountant/financial planner and conduct a cost benefit analysis (CBA) to determine the financial viability of the trust based on your own and planned circumstances.

Below is a simple CBA conducted for a client based on an investment property they are considering purchasing. A $450,000 investment property on a 95% lend with expenses indexed for inflation. It should be noted that income included rent and tax benefits as their property was negatively geared with a positive cash flow.

The client had no other income producing assets in the trust.

1st Year Projection

	Cumulative Income	Cumulative Expenses	Trust Holding Approx Costs	Income Profit / Loss Post Tax
Joint	$26,286	$23,360	$0	**$2,926**
Trust	$20,280	$26,175	$1,500	**-$7,395**

5 Year Projection

	Cumulative Income	Cumulative Expenses	Trust Holding Approx Costs	Income Profit / Loss Post Tax
Joint	$135,822	$117,690	$0	**$18,132**
Trust	$109,843	$131,764	$7,500	**-$29,421**

10 Year Projection

	Cumulative Income	Cumulative Expenses	Trust Holding Approx Costs	Income Profit / Loss Post Tax
Joint	$278,222	$237,732	$0	**$40,490**
Trust	$243,484	$265,879	$15,000	**-$37,395**

20 Year Projection

	Cumulative Income	Cumulative Expenses	Trust Holding Approx Costs	Income Profit / Loss Post Tax
Joint	$621,832	$485,770	$0	**$136,062**
Trust	$603,899	$542,064	$35,000	**$26,835**

Wrap Up

For many people, whether to utilise a Discretionary Family Trust will come down to numbers. It is imperative that if you are considering a trust you:

- Identify the purpose of the trust, why do you need a trust, tax benefit, asset protection etc.

- Conduct a cost benefit analysis to determine the actual cost based on your circumstances, asset position and actual risk.

- Seek the appropriate qualified / licenced professional for advice to ensure you are making the right decision, for the right reasons, at the right time.

Discretionary Family Trusts are a great tool for many people, particularly if you run a business or have properties which have very little lending against them, thus making them high positive cashflow.

Like anything, it's your decision, just make sure you make an informed one.