THE USE OF FAMILY TRUSTS IN SMALL BUSINESS AND FAMILY ENTERPRISE

Dr Mark Giancaspro, Dr Sylvia Villios and
Associate Professor Chris Graves

adelaide.edu.au

CRICOS Provider Number 00123M

‘From a wealth perspective, individual family members contribute to the financial and non-financial wealth of the family unit as a whole. Family trusts enable family wealth to be pooled together and utilised for the benefit of the family as a whole in the most tax-effective manner’.

Anonymous Roundtable participant

ABOUT THE AUTHORS

Mark Giancaspro

Dr Mark Giancaspro is a Lecturer and practising commercial lawyer at the University of Adelaide Law School. He holds an honours degree in Laws and Legal Practice from Flinders University and a PhD from the University of Adelaide. His legal employment background and research interests are primarily commercial, with issues in contract law and its applications being his principal theme. Mark teaches in contract law, commercial law, operational commercial law and sports law, and has published widely on matters including issues with the formation and renegotiation of contracts, the doctrine of consideration, and smart contracts. He currently practices through the Law School's Legal Advice Service in the Adelaide Magistrates Court and is a member of the Australian Commercial Law Association as well as the Adelaide University Research Unit on Military Law & Ethics' (RUMLAE) commercial law division.

Sylvia Villios

Dr Sylvia Villios is a Senior Lecturer at the Adelaide Law School, University of Adelaide. Sylvia researches and teaches in taxation law, particularly focussing on questions about the operation of the Australian tax system, taxation policy, corporate taxation and the role, powers and accountability of the Commissioner of Taxation. She heads the taxation sub-group of the Regulation of Corporations, Insolvency and Taxation (ROCIT) research unit which is based at the University of Adelaide. She is an editorial panel member of the Australian Tax Law Bulletin, Lexis Nexis.

Chris Graves

Associate Professor Chris Graves is a Chartered Accountant and director of the University of Adelaide's Family Business Education and Research Group (FBERG). Since joining the University of Adelaide in 2007, Chris has spent considerable time educating managers and owners of privately-owned firms and has developed the Family Business Adviser accreditation program for Family Business Australia. Chris researches issues surrounding the governance and performance of family businesses. Since 2013, he has undertaken the biennial KPMG-Family Business Australia's 'National Family Business Survey'.

ABBREVIATIONS AND GLOSSARY

Appointor	The party with power to appoint and remove the trustee(s) of a trust and therefore possessing ultimate control of a trust.
APRA	Australian Prudential Regulation Authority.
ASIC	Australian Securities and Investments Commission.
Asset Protection	The act of taking steps to limit the risk of claims made against assets such as by third party creditors or spouses following a divorce.
ATO	Australian Taxation Office.
Beneficiary	A person (or entity) with equitable or beneficial ownership of trust property and for whose benefit the legal title to that same property is held by the trustee.
Bucket company	A company established to receive distributions from a discretionary trust so as to ensure that the trust's income is taxed at the flat company taxation rate of 30%. It captures residual distributions after the family beneficiaries' distributions are made first.
Business Succession	For the purposes of this report, business succession is one component of succession and refers to the transfer of control of the business from one or more family members to another (or other) family members, such as the next generation of the family.
CGT	Capital Gains Taxation; the tax liability arising from a gain made on the sale of an asset: Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (Cth).
Discretionary Trust	A type of trust where the trustee is vested with the discretion to determine which beneficiaries receive a benefit and in what amount.
Div. 7A	Division 7A of Part III of the *Income Tax Assessment Act 1936* (Cth). This Part is intended to prevent the tax-free distribution of profits or assets to shareholders and their associates in the form of payments or loans.
Family Trust	Typically a discretionary trust established for the purpose of holding a family's assets or conducting a family business. Family trusts differ from other forms of discretionary trusts since the pool of beneficiaries is limited to family members (and related corporate beneficiaries and trusts).
FIBER	Acronym describing the five common SEW objectives of family businesses: family control (F) identity through the business (I) binding ties with different stakeholder groups (B) emotional cohesiveness and loyalty among the family (E) and renewal through succession to the next generation (R).
FTE	Family Trust Election; where the trustee makes an election that the trust is a 'family trust' for the purposes of the *Income Tax Assessment Act 1936* (Cth) and the *Income Tax Assessment Act 1997* (Cth): Schedule 2F, ss 272-75 and 272-80 *Income Tax Assessment Act 1936* (Cth). It is an election made for tax purposes and is often made to access trust losses, to pass franking credits to beneficiaries or to access the Subdivision 328-G of the *Income Tax Assessment Act 1997* (Cth) business restructure roll-over. The family trust must nominate an individual (the 'test individual') who forms the point of reference for defining the family group that is taken into account in relation to the election.

GST	Goods and Services Taxation; a value-added tax levied on most goods and services sold for domestic consumption: *A New Tax System (Goods and Services Tax) Act 1999* (Cth).
IEE	Interposed Entity Election; these are similar to Family Trust Elections: Schedule 2F, s272-85(1) *Income Tax Assessment Act 1936* (Cth).
Income Streaming	Provided the trust deed of the trust allows it, a trustee of a trust is able to stream income with special characteristics such as capital gains and franked dividends to any one or more beneficiaries and these amounts retain their same tax character in the hands of the beneficiaries when they are assessed on that income. This allows the minimisation of the tax liability of the family group.
ITAA 1936	*Income Tax Assessment Act 1936* (Cth).
ITAA 1997	*Income Tax Assessment Act 1997* (Cth).
PCG	Practical Compliance Guideline.
PS LA	Law Administration Practice Statement
R&D	Research and development expenditure.
Settlor	The party who creates the trust. They do so generally by drawing up the trust deed to facilitate 'settlement' of the relevant trust property in the trustee(s).
SEW	Socioemotional wealth; the affective value that a family in business together places on the achievement of particular non-economic objectives, often described through the FIBER acronym.
TR	Taxation Ruling; rulings issued by the Commissioner of Taxation, and binding upon the same, with respect to the operation of Commonwealth taxation laws.
Trust	A legal relationship or structure in which one person (the settlor) transfers legal ownership over specific property to another person (the trustee) with instructions that the property is to be administered for the benefit of another person or entity (the beneficiary), or for a particular purpose.
Trustee	The party who holds legal title to trust property and any associated income. They may be a natural person or a corporation.
Trust Assets	The 'property' legally held by the trust. In discretionary family trusts that are carrying on a business, the trust property is normally an active asset such as an operational business premises, and includes plant, property, equipment, goodwill and other business assets.
Trust Deed	The legal document specifying the rules for establishing and operating a trust, and facilitating the initial settlement of trust property upon the trustee. It is typically drawn up by the settlor who is usually a lawyer, accountant or financial planner unrelated to the parties to the trust.
UPEs	Unpaid Present Entitlements; amounts of trust income which the trustee of a trust appoints, but does not pay, to a private company beneficiary.
Vesting	(1) The date at which the trust officially ends (the vesting day), where the trustee will wind up the trust. This usually involves the distribution of all of the assets of the trust to the beneficiaries in accordance with the trust deed; (2) the process of transferring trust property to the trustee.

TABLE OF CONTENTS

ACKNOWLEDGEMENTS

The authors wish to acknowledge the generous financial support of the Australian Small Business and Family Enterprise Ombudsman (ASBFEO), whose funding made this report possible. In particular, we thank Dr Craig Latham (Deputy, ASBFEO) for providing us with the opportunity to undertake this sizeable investigation.

We are deeply appreciative of those legal and accounting professionals who devoted their time to attend our roundtable discussions during May 2019. Their contributions, both scholarly and practical, have been invaluable to this work.

We also wish to acknowledge the tremendous support of Vincent Rocca for his assistance in taking minutes of the roundtable sessions (the data from which was incorporated into this report) and for contributing in part to some aspects of the taxation discussions contained in this report.

We offer special thanks also to Will 'Reggie' Pittaway for his graphic design, specifically the professional diagrams utilised throughout this report.

Finally, we graciously recognise the support of our colleagues throughout this project – in particular, Professor Melissa de Zwart (Dean, University of Adelaide Law School) and Professor Noel Lindsay (Dean, University of Adelaide Business School).

Executive Summary

The law of trusts has a long history dating back to the 12^{th} century. The trust was originally designed principally for estate and succession planning purposes, ensuring property passed on to rightful heirs whenever the original owner decreed or in the event they passed away. By the 20^{th} century, the varieties and uses of trusts had expanded dramatically and in modern times they are used for all manner of purposes such as investment, commercial trading, charitable ventures and business operations. The use trusts in the context of small businesses and family enterprises, in particular, is becoming increasingly popular. In some respects, this is unsurprising; trusts offer a number of benefits compared to other business structures, such as favourable taxation treatment, greater capacity to protect assets, reduced regulatory burden, and better flexibility during the business and family lifecycle.

In Australia, alongside trusts, businesses generally trade through one of three other common legal structures, namely: sole proprietorship, partnership, or company. Although around one in four Australian businesses are operated through a trust, the general incidence of the *use* of trusts is much higher given they are often used in conjunction with other legal entities such as company structures. The legal and financial framework within which trusts operate can create issues for families wishing to operate a family business through a trust. For example, not only are the applicable taxation laws complex to understand and apply, they do not lend themselves to the family business trust structure. This is complicated even further due to regular changes to the taxation laws, which generates further uncertainty and imposes additional compliance costs on small businesses.

Family businesses often experience difficulty raising capital and encounter considerable problems when using retained earnings of the trust for reinvestment back into the business due to the operation of Division 7A of the *Income Tax Assessment Act 1936* (Cth). Further, there is some evidence to suggest that banks struggle with trusts and trust deeds, which can make obtaining finance challenging for businesses carried on through a trust.

Small businesses often need to be restructured during their lifecycles, as circumstances and needs change and the initial structure adopted becomes inappropriate. Restructuring involves advisers navigating through the complex capital gains tax roll-over provisions in the tax law, as well as other Federal and State tax laws, to ensure the roll-over is able to occur tax free. If the adviser misinterprets or misapplies the tax law, this can lead to the imposition of a significant tax liability for a business which could erode its asset base or create considerable cash flow issues which threaten the business' ongoing viability. A similar situation applies with respect to the operation of the Small Business CGT Concessions in Div 152 of the *Income Tax Assessment Act 1997* (Cth), when the owners decide to sell their business or business assets, impacting on retirement funds.

The ATO's approach to trust resettlements is also problematic and, in many cases, does not allow business owners to modernise their trust deeds without creating an unintended but significant taxing point. Similarly, the rule against perpetuities, which applies in all Australian States except South Australia, limits the life of a trust to 80 years or less. After that point, the trust 'vests', which creates a significant taxing point that is a considerable impediment on family business succession. Restructure costs will also be incurred. Moreover, there are a number of tax and government grants that cannot be accessed by businesses being carried on through a trust structure, such as the Research and Development Tax-offset under Division 355 of the *Income Tax Assessment Act 1997* (Cth), which can only be accessed by businesses which are carried on through a corporate structure.

While one of the greatest benefits of trust structures is the flexibility that they can provide, this can also create problems for family business succession planning. Trust property cannot be divided into equal shares between children, which can make it extremely challenging for business owners to pass their business onto the next generation.

Extensive reform is required in order to address the inadequacies of the currently legal and regulatory framework within which trusts operate. A number of recommendations have been made throughout this Report and are listed in Part 6. These recommendations are aimed at supporting small business and family enterprise, eliminating unintended but significant taxing points during the lifecycle of a business, promoting business succession from generation to generation, and eliminating distortions in the tax treatment of various business structures by applying the tax laws uniformly for the taxation of all business structures including companies, trusts, partnerships and sole proprietorships. Such measures, it is suggested, should be supported by additional initiatives, such as educational programs for family and small business parties and the development of help resources.

The use of Family Trusts in Small Business and Family Enterprise

This report investigates the issues that arise with respect to the use of family trusts in small business and family enterprise. It is designed to identify how family trusts are most commonly used in small or family business structures, the legal framework within which family trusts operate, the benefits of carrying on a business through a family trust, and the problems or concerns with respect to the use of family trusts in small business or family enterprise. The report also makes a number of recommendations with respect to how the concerns or issues identified can be overcome.

The report is separated into five parts. Part 1 discusses the nature of a family trust. It outlines its basic elements, including the parties and other central features. It also explains how family trusts differ from other types of trusts and business structures, and distinguishes trusts from other forms of legal relationship.

Part 2 considers the legal framework within which family trusts operate in a business context. Specifically, it provides an overview of the case law and statute law governing trusts, with reference to the provided example of a 'typical' family trust deed.

Part 3 introduces the concept of carrying on a business through a family trust or including a family trust as part of the overall business structure. The prevalence of family trusts in Australia, the common business structures involving family trusts, and the various factors that influence the choice of business structure are discussed in turn.

Part 4 discusses the benefits of carrying on a business through a family trust, and helps to explain the growing popularity of their use in the family business context. Aside from the principal benefit of favourable taxation, the benefits of asset protection, reduced regulatory burden and overall flexibility are all examined.

Finally, Part 5 considers a variety of issues that can arise during the lifecycle of a business carried on through a family trust. Many of these issues can impact dramatically upon the ability of the business owners to preserve the asset base of the business, upon cash flow, and even upon the ongoing viability of the business. In light of their current prevalence within the Australian commercial landscape and growing popularity, it is essential that potential solutions to these issues be considered. The report therefore concludes with a series of recommendations with respect to legal and regulatory reform in the space of family trusts.

Consultation Approach

The authors determined that, given the practical nature of the subject of this report, the involvement and input of legal and accounting practitioners that specialise in advising small business and family enterprise was critical. On 3 May 2019, the authors hosted a roundtable for legal experts and tax accountants, to discuss the consultation questions prepared by the authors (refer to Appendix 2). The questions were circulated to attendees prior to the roundtable session. The roundtable was conducted at the University of Adelaide with eight advisers in attendance. The minutes from this roundtable session are included as Appendix 3.

On 10 May 2019, the authors hosted a second roundtable for legal experts and tax accountants. The second roundtable was similar to the first roundtable but was more directed. For example, a business structures handout prepared by the authors (refer to Appendix 5) was circulated to attendees based on information gathered from the first Roundtable. The aim was to ascertain how family trusts are most commonly used in business structuring and what factors drive this decision. Ten advisers were in attendance. The minutes from the second roundtable session can be found in Appendix 4.

Both roundtable sessions were conducted under Chatham House rules.

The authors are grateful for the time and valuable contributions of all participants who contributed to the roundtable discussions. The authors have had careful regard to the various views expressed to it during the roundtable discussions. These views are referred to throughout this report.

1. What is a Family Trust?

1.1. Introduction

Comprehending the nature of a family trust requires a basic understanding of trusts generally. A trust describes a legal relationship or structure in which one person (the *settlor*) transfers legal ownership over specific property to another person (the *trustee*) with instructions that the property is to be administered for the benefit of another person or entity (the *beneficiary*), or for a particular purpose. The essence of a trust is dual ownership over the same property: the trustee is vested with *legal* ownership and the beneficiary or beneficiaries enjoy *equitable* – or *beneficial* – ownership.

Assume, for example, that a parent owns a piece of real estate (which they lease as a private residence) and wishes for the property to pass onto their 17-year-old child when the child reaches age of majority. The parent currently maintains and oversees the property and establishes a trust over the same, appointing themselves as trustee. In this scenario, although the child is the intended beneficiary and therefore enjoys a beneficial interest in the property, it is the parent who is trustee and whose name is contained in the trust deed as such. Accordingly, the parent holds legal title to the property, which takes priority over their child's equitable title, even though the child is the party who is rightfully entitled to the property.

Trusts were not originally conceived as a vehicle for doing business. Rather, they were devised largely for estate and succession planning purposes. The trust as we know it derives from the English common law system, which historically favoured the medieval predecessor of the trust known as the 'use'. 'Under the use, land was transferred by common law conveyance, to A (the "feofee to use", the modern trustee) to the use of B (the "cestui que use", the modern beneficiary).[1] Given the political and social turmoil which engulfed England during the Crusades and the tempestuous reigns of Richard II and Henry IV, it was often the case that landowners vested control over their holdings to others. The average life expectancy was very low at the time,[2] and the ways in which landowners could meet premature death were many and varied (disease, war etc.). As such, property transfers to beneficiaries who were not yet of age were somewhat common. The trust evolved through the courts of equity as the principal mechanism to achieve such transfers and, in the interim, ensure the trust property was appropriately dealt with for the benefit of its intended recipients. During the 18th and 19th centuries, the term 'trust' became the common label for the relationship between the legal and equitable titleholders – trustee and beneficiary respectively.

---

[1] G E Dal Pont, *Equity and Trusts in Australia* (Thomson Reuters, 5th ed, 2011) 486.

[2] Estimates for the life expectancy of landholders around this time vary but are generally between 25-30 years: M A Jonker, 'Estimation of Life Expectancy in the Middle Ages' (2003) 166(1) *Journal of the Royal Statistical Society* 105. The current life expectancy for Australians is 82.5 years: Australian Institute of Health and Welfare, *Deaths in Australia* (18 July 2018) <https://www.aihw.gov.au/reports/life-expectancy-death/deaths-in-australia/contents/life-expectancy>.

The last century has witnessed the dramatic expansion in the varieties and uses of trusts. Rather than being solely a landholding device, as it once was, the trust is now used widely in commercial operations. In some cases, trusts have supplanted companies as the principal vehicle for business (though, as discussed in Part 3, for a variety of reasons, trusts tend to feature in the business setup as a shareholder, with the business itself operating as a corporate entity). There are several ways in which a trust can be used for commercial purposes, as will be discussed later in this report.

Trusts can be classified in a number of ways, one being by virtue of how the income and/or capital of the trust property is distributed. In a *fixed trust*, the beneficiaries have a fixed entitlement to the trust income and/or capital, which the trustee is bound to distribute. Alternatively, in a *discretionary* trust, the trustee is vested with the discretion to determine which beneficiaries receive a benefit and in what amount. Either way, the arrangement is detailed within and facilitated by the relevant trust deed (see 1.2.6).

A family trust is typically a discretionary trust established for the purpose of holding a family's assets or conducting a family business.[3] It is one of the most popular business and asset holding structures in Australia for a variety of reasons to be discussed in Part 3. Family trusts differ from other forms of discretionary trust since the pool of beneficiaries is generally limited to family members (or possibly even other related companies – 'corporate beneficiaries' – or trust structures). As explained in greater detail further on,[4] the trustee of the family trust has a discretion (choice) as to who to allocate the income or capital of the trust to, provided that that beneficiary is within the class of beneficiaries specified under the terms of the trust deed.

The archetypal family business structured as a trust will feature a trust as the operating or head entity, an individual or corporate trustee, and a group of beneficiaries including both family members and a related bucket company.[5]

1.2. Basic 'Elements' of a Family Trust

There are several components to a family trust. The parties invariably include: an appointor, a settlor, a trustee, and one or more beneficiaries. The duration and content of their roles differ significantly and are outlined below.

[3] See generally: Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Family Businesses in Australia – Different and Significant: Why they Shouldn't be Overlooked* (20 March 2013) <https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Completed_inquiries/2010-13/fam_bus/report/c06#c06f23>.
[4] See 1.2.3-1.2.4.
[5] Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Family Businesses in Australia – Different and Significant: Why they Shouldn't be Overlooked* (20 March 2013) p 125 <https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Completed_inquiries/2010-13/fam_bus/report/c06#c06f23>. See Diagram 1 at 3.4.

1.2.1. Appointor

The appointor is the party with power to appoint and remove the trustee(s). By virtue of this power, the appointor effectively owns and controls the trust. There may be more than one appointor. In a family trust, the appointor is normally one or both of the parents of the respective family, and plays a 'protective' role by ensuring trustees do not abuse their powers. It is for this reason that the appointor is sometimes colloquially referred to as the 'guardian' of the trust. Where a family business is operating through the trust, the appointors will invariably be the proprietors of the business. The appointor typically draws their power to appoint and remove trustees from the trust deed itself, though the Trustees Acts in each state and territory stipulate alternative persons who can appoint trustees, as well as the circumstances in which such appointments can be made.[6] For example, an appointor may remove a trustee who: dies; remains out of the state for more than 12 months; desires to be discharged; refuses to act; or is incapable of fulfilling or unfit to fulfil their office (e.g. through prolonged illness, mental incapacity, or misconduct). Most commonly however, an appointor might simply remove a trustee pursuant to an express power to do so under the trust deed.

In many modern trust deeds, particularly in the family trust context, the appointor is also empowered to do a great number of other things to keep the trustees in check and otherwise administer the trust. For example, they may be vested with the rights to veto a trustee's decision, extend or bring forward a vesting date,[7] add or exclude beneficiaries, or otherwise amend the trust deed. The deed might even require that the trustee seek the appointor's consent prior to carrying out a particular transaction, or otherwise vest the appointor with stronger 'supervisory' powers over the trustee. Of course, the appointor's most significant power is that to appoint and remove trustees.

1.2.2. Settlor

The settlor is the party who creates the trust.[8] They do so generally by drawing up the trust deed to facilitate 'settlement' of the relevant trust property in the trustee(s) on the condition they hold it for the benefit of the beneficiaries. Once this occurs, the trust property is said to have been 'vested' in the trustee. This process attracts a nominal establishment fee or 'settlement sum', normally in the range of $10. The amount may well be more and account for any applicable stamp duty or other transfer taxes. Generally, once established, more substantial monies or assets are then transferred or loaned to the trust. This serves to minimise stamp duty liability, which in some Australian jurisdictions is calculated upon the value of the trust property on establishment.[9] There are no taxation liabilities attaching to the mere establishment of a trust, however taxation liability does affect the trust, trustees and beneficiaries post-creation.

---

[6] *Trustee Act 1925* (ACT), s 6; *Trustee Act 1925* (NSW), s 6; *Trustee Act 1893* (NT), s 11; *Trusts Act 1973* (Qld), s 12; *Trustee Act 1936* (SA), s 14; *Trustee Act 1898* (Tas), s 13; *Trustee Act 1958* (Vic), s 41; *Trustees Act 1962* (WA), s 7.
[7] On vesting, see 1.2.2 and 5.9.
[8] In the case of testamentary trusts created through a valid will, the settlor is known as the 'testator'. See further 1.3.6.
[9] At time of writing, of all Australian states and territories, only Tasmania, Victoria, New South Wales and the Northern Territory impose stamp duty liability for the establishment of a trust.

With discretionary family trusts, the settlor is invariably an unrelated lawyer, accountant or financial planner engaged by the party wishing to establish the trust. Their role is normally restricted to the trust's initial establishment, often ceasing with signature upon the trust deed. The settlor should not be a beneficiary of the trust nor the parent of a beneficiary who is a minor, as this can have adverse taxation implications.

Strictly speaking, a settlor has no 'duties' in a trust arrangement. Their role is largely restricted to the initial establishment of the trust. Given they are normally an unrelated party, in respect of family trusts, the settlor generally exits the relationship and has no further involvement once they have drawn up and signed off on the trust deed to facilitate settlement. In abstract terms, the settlor's initial and sole 'power' and 'duty' is to create the trust.

1.2.3. Trustee

A trustee holds legal title to trust property and any associated income. They may be a natural person or a corporation. Indeed, there is a growing trend to designate a corporate entity as a trustee. Some family trusts even nominate a foreign company, which is permitted at law.[10] There are several reasons why a foreign company might be utilised. For example, the actual family company may operate overseas, or simply have more assets making it more capable of withstanding creditor claims if things go awry. Such an appointment might also be one step in a phased takeover of the family business by a foreign entity. The most likely reason, however, is to avoid taxation liability as the foreign entity would only pay tax on Australian sourced income.[11]

There are also some disadvantages to designating a foreign corporate entity as trustee. For example, where the entity is also a beneficiary, this arrangement may attract foreign ownership surcharges and restrictions. To demonstrate, if the trust property involves any kind of residential or commercial real estate, the foreign company must seek foreign investment approval before acquiring interests in the property.[12] Foreign ownerships surcharges in each Australian state may also apply.

Trustee companies established for the purpose of acting as executors or trustees of deceased estates, or for the investment or management of client funds, require approval under the relevant Trustee Companies Acts of the respective jurisdiction.[13]

Importantly, a company's (whether domestic or foreign) capacity to manage the trust is somewhat restricted: it must act both within the trust's objects and within the powers given to the trustee under the trust deed.[14]

---

[10] *Re McPhillamy's Trusts* (1909) 10 SR (NSW) 42.
[11] On the taxation benefits of trusts, see Part 4.
[12] *Foreign Acquisitions and Takeovers Act 1975* (Cth).
[13] *Trustee Companies Act 1947* (ACT); *Trustee Companies Act 1964* (NSW); *Companies (Trustees and Personal Representatives) Act 1981* (NT); *Trustee Companies Act 1968* (Vic); *Trustee Companies Act 1988* (SA); *Trustee Companies Act 1953* (Tas); *Trustee Companies Act 1984* (Vic); *Trustee Companies Act 1987* (WA).
[14] *Re Levin & Co Ltd* [1936] NZLR 558.

It is not uncommon in family trust arrangements for the appointor to also be one of many trustees,[15] and potentially a beneficiary as well. The trustees legislation in some Australian jurisdictions restricts the number of trustees that can be appointed to a family trust.[16] In family businesses operating through a trust, the parents will normally act as the appointors and trustees, or alternatively act only as appointors of the trust and control the corporate trustee through their appointment as the directors and shareholders of the corporation. The parents will also typically comprise the principal beneficiaries of the trust and the broader family group.

The trustee is subject to a number of obligations and duties and also enjoys several very broad powers and rights stemming from their position. These are imposed both by statute and the common law.[17] The trustee's general role is to hold and control the trust property for the benefit of the beneficiaries.[18] They may mortgage, improve, lease, repair, and under certain conditions sell trust property. They can also invest trust funds, carry on a business, and exercise any other powers granted under the trust deed or by law. Essentially, the trustee has day-to-day managerial control over the trust.

The trustee's most significant power in a discretionary family trust is to make distributions to the relevant class of beneficiaries. This is discussed in greater depth within the context of those beneficiaries' interests at 1.2.4. Typically, the parents, either as natural trustees or as proprietors of the corporate trustee, will distribute the trust income amongst themselves and their children or other relatives (and possibly a bucket company) as the relevant beneficiaries, in the amounts they themselves determine. This discretion will, of course, be subject to the terms of the trust deed, but normally it is unbridled.

Given that a trustee is the legal owner of trust property, they are – unless otherwise stipulated in the relevant trust deed – personally liable to third parties, including creditors, for any debts or obligations they incur (though as discussed shortly, and in greater depth in 4.3, trustees are normally entitled to claim indemnity out of the trust assets until such time as the asset pool is exhausted).[19] As mentioned earlier, a trustee may be appointed and removed by the appointor of the trust.

The trustees legislation broadly outlines the duties of trustees in any type of trust. Some of the more significant duties include those to:

---

[15] The appointor cannot be the *sole* trustee.

[16] The limit is 4 in the ACT, NSW, Queensland, Victoria and WA. There are no limits in the NT, SA and Tasmania.

[17] While the common law also vests trustees with a number of other important duties and powers, these are largely codified through the trustees legislation and invariably incorporated into the relevant trust deed.

[18] 'One obligation of a trustee which exists by virtue of the very office is the obligation to get the trust property in, protect it, and vindicate the rights attaching to it. That obligation exists even if no provision of any statute or trust instrument creates it. It exists unless it is negated by a provision of any statute or trust instrument': *CGU Insurance Limited v One.Tel Limited (In Liq)* (2010) 242 CLR 174, 182. In the case of charitable trusts, the trustee is also required to hold and control the trust property so as to serve the particular purpose of the trust.

[19] This is one of several reasons why, as explained further in 4.3, a corporate trustee is often preferred over individuals acting as trustees. A corporate entity will typically have a deeper asset pool and also provide greater protection for those assets.

- act in the best interests of, and take advice from, the beneficiaries;
- keep and maintain proper accounts regarding the administration of trust property;
- exercise care, diligence and skill when investing trust funds;
- act impartially towards the beneficiaries; and
- avoid conflicts of interest, or attainment of profit,[20] arising from the position of trustee.

The common law also imposes a number of duties upon trustees. For example, a trustee is expected to invest trust monies (as legally authorised and/or directed) in order to benefit the trust.[21] It is also a general requirement that the trustee pays the correct beneficiaries. This is a logical extension of the general duty to properly administer the trust.

1.2.4. Beneficiary

As was mentioned earlier, in trust arrangements, the trustee is vested with *legal* ownership while the beneficiary or beneficiaries enjoy *equitable* or *beneficial* ownership. As such, the term 'beneficiary' describes a person with equitable or beneficial ownership of trust property and for whose benefit the legal title to that same property is held by the trustee.[22] As with most family trusts, the beneficiaries are normally the children or other family relatives of the parent trustees, along with the trustees themselves.[23]

Importantly, in a discretionary family trust, the trustee (whomever that is) retains discretion to make distributions from the trust at their discretion. They are also typically empowered through the trust instrument to determine the respective amount of each beneficiary's entitlement.[24] Unless the relevant trust deed provides otherwise, the trustee is not obligated to make a distribution to the beneficiaries at all.[25] Accordingly, discretionary beneficiaries enjoy no immediate entitlement to income as it accrues,[26] nor any beneficial interest in the trust property.[27] If the trustee opts to pay a beneficiary, it is not by virtue of the beneficiary's right but rather a consequence of the trustee's decision to make the payment.[28] Consequently, they are a 'beneficiary' only insofar as the trustee in their sole discretion

---

[20] This duty derives from the fiduciary principle that a trustee must not benefit from their position: *Robinson v Pett* (1734) 3 P Wms 249; 24 ER 1049. It may of course be modified by the trust deed, the courts, the beneficiaries (when they are of full legal capacity), or by operation of law. Indeed, the duty to draw profit from one's position as trustee will invariably be modified where a business structured as a trust is being administered by the trustee. Where the trustee is also one of the beneficiaries of the trust, they will be entitled to their share of the business profits as stipulated within the trust deed.
[21] *Byrne v Kendle* (2011) 243 CLR 253.
[22] The old phrase from Law French used to describe beneficiaries was *cestui que trust* ('the person for whose use the trust was made').
[23] See sample trust deed in Appendix 1 at cl 1.6.
[24] *McPhail v Doulton* [1971] AC 424.
[25] *Kennon v Spry* (2008) 238 CLR 366.
[26] *Queensland Trustees Ltd v Commissioner of Stamp Duties (Qld)* (1952) 88 CLR 54.
[27] *Australian Securities and Investments Commission v Carey (No 6)* (2006) 153 FCR 509.
[28] *Gartside v Inland Revenue Commissioners* [1968] AC 553.

determines them to be so. It is, therefore, as the Australian courts have observed, misleading to use terms such as 'beneficial' or 'equitable interest' when speaking of the interest of beneficiaries under a discretionary trust.[29]

Regardless of a discretionary family trust's structure, the beneficiaries still enjoy a number of rights at common law and under the trustees legislation. For example, they are entitled to access any information pertaining to the management of the trust.[30] Such information might include financial statements, details of asset holdings and the like. A beneficiary can also enforce their right to have the trust administered correctly.[31] The courts will not interfere with a trustee's discretionary decision as to distributions unless they have acted in bad faith, which typically requires proof of capriciousness, malice or gross irresponsibility.[32] There must, at the least, be evidence that the trustee gave genuine consideration to exercising a power to make distributions. Where a trustee opts not to pay the beneficiaries at all, or to pay a beneficiary outside of the stipulated class, for example, the 'true' beneficiaries may take action. It is a legal requirement that trustees give honest and faithful consideration to the exercise of their discretion. Again, in family business settings, favouritism, resentment or other emotions may negatively affect the relationships between the parties and the effective operation of the trust.

Beneficiaries are, as the title suggests, the parties for whose benefit the trust property is held and administered by the trustee. As such, they have no real 'duties' to speak of. Rather, they rely upon the trustee's faithful fulfilment of his or her duties. It is therefore more accurate to say that beneficiaries have a number of rights which are enforceable against the trustee. Many of these were discussed above. In addition to those rights, beneficiaries are entitled to seek court orders (injunctions) restraining any actual or proposed action on the part of the trustee which amounts to a breach of trust.[33] They are also at liberty to initiate legal proceedings so as to compel performance of the trust and protect their beneficial interests. This may require the removal of a trustee and appointment of a replacement.[34] Again, beneficiaries to a discretionary trust – which incorporates the vast majority of family trusts – are in a more difficult position as they are at the mercy of the trustee's prerogative to make distributions to them. Short of proof that the trustee is not giving honest and faithful consideration to the exercise of their discretion to make distributions, the courts will not intervene. This will be a difficult exercise for any beneficiaries to a discretionary trust, especially in family trust arrangements where the parties are invariably bound by blood or marriage and therefore subject to the added complication of personal opinions, emotions and family conflict.

---

[29] See *MSP Nominees Pty Ltd v Commissioner of Stamps (SA)* (1999) 198 CLR 494; *Federal Commissioner of Taxation v Ramsden* (2005) 58 ATR 485.
[30] *Spellson v George* (1987) 11 NSWLR 300.
[31] *R & I Bank of Western Australia Ltd v Anchorage Investments Pty Ltd* (1992) 10 WAR 59.
[32] *Cock v Smith* (1909) 9 CLR 773.
[33] *Yorkshire Miners Association v Howden* [1905] AC 256.
[34] *Miller v Cameron* (1936) 54 CLR 572.

1.2.5. Trust Property

It is trite law that no trust can exist without certain and identifiable property. Without it, the trust is void. The 'property' of the trust is its subject matter, normally in the nature of some type of tangible asset such as real property (land) or personal property (chattels or moveable possessions). It might even be an intangible item, such as company shares or an investment fund. In discretionary family trusts that are carrying on a business, the trust property is normally an active asset such as an operational business premises, plant, property, equipment, goodwill and other business assets. The income these forms of property attract makes up the pool of funds or other benefits from which distributions are made by the trustee to the beneficiaries (at their discretion and subject to any applicable trust deed provisions). The business may eventually be sold or otherwise disposed of, with any proceeds again being distributable to beneficiaries in the trustee's discretion.

As will be discussed in Part 3, the relevant 'trust property' may actually be comprised of the *assets* – such as land, plant and equipment – associated with the family business, with the business itself being structured as a corporation and holding said assets in the trust. For discretionary family trusts, particularly for those operating as businesses, the most common approach is for the trust to hold equity and other appreciating assets such as land while the company operates as the trading entity.

1.2.6. Trust Deed

A trust deed, also sometimes referred to as a 'deed of settlement', is the legal document specifying the rules for establishing and operating a trust, and facilitating the initial settlement of trust property upon the trustee. As stated earlier, it is typically drawn up by the settlor who is usually a lawyer, accountant or financial planner unrelated to the parties to the trust deed. The trust deed must be properly executed according to the relevant state or territory laws and signed by the settlor and trustees, at which point the settlor transfers the trust property to the trustee(s) and 'vests' them with the same to create the trust. Family trust deeds will set out such matters as how distributions are to be made, how new trustees or beneficiaries may be added, and the rights and obligations of the parties. It is prudent for trust deeds to be regularly reviewed and updated as required. An example of a typical family trust deed is included in this report as Appendix 1.

In the overwhelming majority of cases, where a family business is operating through a trust, and irrespective of whether or not the trust is holding real property, a trust deed will be executed. However, the law of equity is concerned more with the intent of the party seeking to benefit another out of specified property through a trust than with the form of this arrangement. As such, there is actually no common law requirement for valid *inter vivos* trusts – those created during life – to be created by writing. The owner of the property can simply either *declare* a trust over the same (retaining legal title in the property but holding it on trust for the beneficiary) or *transfer* legal title in the property to a trustee to hold on trust for the beneficiary.

However, certain forms of trust are subject to statutory requirements.[35] To provide a typical example, Section 29 of the South Australian *Law of Property Act 1936* reads:

> **29—Instruments required to be in writing**
>
> (1) Subject to the provisions hereinafter contained with respect to the creation of interests in land by parol—
>
> (a) no interest in land can be created or disposed of except by writing signed by the person creating or conveying the same, or by his agent thereunto lawfully authorised in writing, or by will, or by operation of law;
>
> (b) a declaration of trust respecting any land or any interest therein must be manifested and proved by some writing signed by some person who is able to declare such trust or by his will;
>
> (c) a disposition of an equitable interest or trust subsisting at the time of the disposition must be in writing signed by the person disposing of the same, or by his agent thereunto lawfully authorised in writing or by will.
>
> (2) This section shall not affect the creation or operation of resulting, implied, or constructive trusts.

As with the equivalent provisions in the other jurisdictions, this provision is essentially designed to ensure that significant pledges of interest in land be evidenced in writing. To avoid overlap with subsection (b), subsection (a) can be read either as requiring *legal* (not equitable) interests in land to be created of disposed of in writing, or as applying only to dispositions of equitable interests in land which occur other than through the creation of a trust. This means, in theory, that a trust pertaining to land can be created orally but will only be enforceable once evidence in some form of writing from the settlor is generated. Subsection (c) basically ensures that no secretive oral transactions transferring equitable interests occur. If, for example, a beneficiary wanted to assign his or her beneficial interest in land to another person, they would have to do so in writing. Again, however, family businesses conducted through a trust structure will invariably have an underlying trust deed, even where the trust holds no real property. This deed will not only record any transfers of trust property in writing but ensure the property is administered correctly.

It is undoubtedly the case that the trust deed will, in time, require variation. For example, it might be necessary to vest trustees with specific powers not conferred via the trust deed, legislation or the common law. Variation clauses in a trust deed are construed according to their natural meaning and so as to accomplish a practical outcome.[36] These clauses may empower a trustee, beneficiary or even a third party to vary the deed. Any such power must, of course, be exercised sensibly in accordance with the rule that a party with the power to dispose of trust property (irrespective of

---

[35] *Civil Law (Property) Act 2006* (ACT), s 201; *Conveyancing Act 1919* (NSW), s 23C; *Law of Property Act 2000* (NT), s 10; *Property Law Act 1974* (Qld), s 11; *Law of Property Act 1936* (SA), s 29; *Conveyancing and Law of Property Act 1884* (Tas), s 60; *Property Law Act 1958* (Vic), s 53; *Property Law Act 1969* (WA), s 34. These provisions largely re-enact provisions of the historical *Statute of Frauds 1677* (Eng), an old English statute which required certain types of contract of particular significance and value to be recorded in writing. The statute was designed to prevent hidden oral agreements or transactions with respect to particular types of property defrauding those who were rightfully entitled to them.

[36] *Kearns v Hill* (1990) 21 NSWLR 107.

any interest they have in that property) must do so in good faith and for a proper purpose that aligns with the donor's intentions.[37]

In the family trust context, given the transient nature of many contemporary family relationships, it might also be the case that former spouses need to be removed as primary beneficiaries, or that appointors and/or trustees have to be changed. If a family business is operating through a trust and acquires or disposes of particular assets, or undergoes a restructure, this will also impact upon the trust deed and require alteration. Most trust deeds will permit their variation, however most powers to vary will, particularly in the case of older trust deeds, contain limitations. Prudent and accurate interpretation is vital to ensure that the trust is not breached.

Ironically, anecdotal evidence indicates that parties to a discretionary family trust seldom bother to amend their trust deeds, even when the trust's assets change. The advisers in the first roundtable noted that trustees and/or beneficiaries often sell or otherwise dispose of assets accounted for in a trust deed without considering the need to vary the related trust deed. This can lead to confusion as well as adverse legal and taxation implications. The courts too have some discretion to vary trust deeds both at common law and under the trustees legislation though the discretion is restricted and rarely used. The courts are loathe to interfere with trusts, which are fundamentally private instruments reflecting the intentions of the settlor.

Parties seeking to vary a trust deed would be wise to seek professional advice. This is to ensure they have made an appropriately measured decision that is commensurate with the ideals of the trust. It also ensures they do not inadvertently bring about a *resettlement*. While there is no precise definition for the term 'resettlement', it essentially describes 'the alteration to a trust that results in changes to the class of beneficiaries or the nature of their beneficial interests'.[38] Any significant change to a trust is likely to impact upon either of these things, in which case the trust is likely to be taken to have been resettled. An unplanned or unintended resettlement can have significant financial implications. It might, for example, trigger stamp duty liability and even attract capital gains tax.[39]

Again, any variations to a trust deed should be carried out by the party authorised under the deed and made within the scope of the powers conferred by the deed. Professional advice generally serves to avoid any pitfalls associated with improper variation or correct variation which triggers adverse consequences. It is regrettable that many Australian family business proprietors whose businesses operate through discretionary trusts infrequently seek guidance before embarking on any variations.

In family trusts, particularly where the settlor is a family member seeking to benefit descendants or other relatives, they may opt to include an indication of the way they would like the trustees to exercise their discretion. Such indications may be incorporated into the trust deed itself, or documented in a separate (generally confidential) 'letter

---

[37] *Dwyer v Ross* (1992) 34 FCR 463.
[38] Gino Dal Pont and Tina Cockburn, *Equity and Trusts in Principle* (Thomson Reuters, 2014) 373.
[39] For a more detailed discussion of resettlement, see 5.12.

of wishes' appended to the trust deed. The letter of wishes is sometimes referred to as the 'memorandum of wishes'. This document is not legally binding, however the trustee is entitled to take it and the views of the beneficiaries into account in exercising their discretions under the trust deed.[40]

1.3. Distinguishing a Family Trust from Other Types of Trusts

1.3.1. Fixed vs. Discretionary Trusts

Discretionary family trusts are unique from other types of trust in a number of ways. For a start, it is simplest to recognise one of the more fundamental distinctions between *fixed* trusts and *discretionary* trusts. As discussed earlier in 1.1, a fixed trust is one in which the beneficiaries have a fixed interest in the income and/or capital of the trust property, in accordance with the terms of the trust. The beneficiaries are empowered to enforce both the administration *and* distribution of the trust property. In contrast, as explained above, in 1.2.4, discretionary trusts only permit the beneficiaries to enforce correct administration of the trust; the trustee retains full discretion to apply the income and/or capital of the trust property to the beneficiaries.

1.3.2. Private vs. Public Express Trusts

Whereas a private trust such as a discretionary family trust is intended to benefit one or more specific natural or corporate persons (the relevant 'class' of beneficiaries), a public trust is typically charitable in nature and designed to serve particular purposes which may benefit any number of persons. Of course, as with all trusts, certainty of object is essential and so provided those who ultimately benefit from the public trust are part of an identifiable 'class' of society, the trust will be valid.[41] Classic examples include charitable trusts for the relief of the poor, the advancement of education, or the advancement of religion. Both private and public express trusts may be created during one's life or through the operation of will, with the trustees of either being bound by essentially the same rules under common law and statute.

1.3.3. Unit Trust

A unit trust is a trust in which the beneficial interest in the relevant trust property is divided through the trust deed into fractions (units) which can be sold or granted, usually to members of the public. The holder of one of more units becomes a beneficiary of the unit trust. Naturally, all beneficiaries (unitholders) are readily ascertainable at any given time, making the unit trust an example of an express fixed trust. The unit trust's net income is taxed as trust income, generally payable by the beneficiaries as the trust's 'investors'. The trust property is purchased by a 'manager', which in modern times is usually a proprietary company, and which may in time acquire new trust property that appreciates

---

[40] *Hartigan Nominees Pty Ltd v Rydge* (1992) 29 NSWLR 405; *Monaghan v Monaghan* [2016] NSWSC 1316.
[41] See *Verge v Somerville* [1924] AC 496.

in value. The unit-holders each enjoy a fixed interest in the capital and income of the unit trust. As such, it is a vehicle for investment. This arrangement closely resembles that between a company and its shareholders. However, where a unit-holder has an equitable interest in the unit trust's assets, a shareholder has no such interest in the assets of the company.[42]

1.3.4. Trading Trust

A trading trust is a trust established for the purposes of carrying on a business. A trustee (person or company) will usually receive, hold and use property on behalf of the beneficiaries in accordance with the powers stipulated in the trust deed, the ultimate aim being for the trust property to accumulate in value. The trustee in trading trusts is usually a limited liability corporation. The trust property underpinning the business will be held either on a discretionary trust for a class of beneficiaries or on a fixed trust for unit-holders.[43] Family and small businesses tend to utilise trading trusts given the payroll taxation and income taxation benefits. However, they can be complex and expensive to set up and also tend to have other significant compliance costs.

1.3.5. Superannuation Trust

Some trusts are established purely to operate as superannuation schemes. A superannuation trust works by allowing its 'members' – the beneficiaries – to make contributions to the trust so as to provide for their retirement. A member, being an employee of a business, makes periodic contributions to the trust which then invests the funds and returns a host of benefits to the member upon his or her retirement. The major benefit will be a lump sum retirement payout or a perpetual pension, as well as additional allowances such as disability and death benefits. Any trust operating as a superannuation fund must comply with the requirements of the *Superannuation Industry (Supervision) Act 1993* (Cth). The trust is supervised by a number of regulatory bodies, including APRA, ASIC and the Federal Commissioner of Taxation.

The two main types of superannuation trust fund are (1) the defined benefit scheme (which quantifies retirement payout based upon a series of variables such as salary at retirement and duration of membership with the scheme) and (2) the defined contribution or accumulation scheme which quantifies retirement payout based upon the number of total contributions made by members and the fund's own earnings.

1.3.6. Testamentary Trust

A testamentary trust is one which arises through operation of a testator's will upon their death. The concept of disposition of a deceased's estate is commonly understood. The trust aspect arises from the fact that the settlor (in this

---

[42] *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598.
[43] Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Family Businesses in Australia – Different and Significant: Why they Shouldn't be Overlooked* (20 March 2013) 124.

context, the testator)[44] has stipulated instructions as to what is to happen with all forms of property comprising his or her estate. Provided that the will establishing the testamentary trust complies with the provisions of the relevant wills and succession Acts in each Australian jurisdiction and is valid, the trust itself will be valid. The requirements for validity are generally the same throughout the states and territories.[45] As explained in 2.3.4, the fundamental requirements are that the will be in writing, signed by the testator (or a lawful representative acting under the testator's direction) at the end of the document, and signed by two or more witnesses who attest to the will in the testator's presence.

As sometimes happens, where a parent owner of a family business passes away and seeks to vest legal title in the business to his or her spouse or children, a clause to this effect will be inserted into the testator's will *inter vivos* and be enlivened at the time of their death. Depending on how the business is structured, it will most likely survive given that corporate entities are separate legal persons.[46] The executor of the estate will first administer the deceased's estate once a grant of probate comes into effect. The trustee, who may well also be the executor, then ensures that the property the subject of the testamentary trust is vested in the appropriate beneficiaries. Any residue of the estate which has not been correctly disposed of through the terms of the will – a situation known as 'partial intestacy' – is distributed according to the statutory rules on intestacy and may be subject to claims from the deceased's relatives.

Difficulties can sometimes arise in the family trust context where, independent of their will, a testator discretely establishes a testamentary trust over particular trust property. In such scenarios, the details of the trust and the identity of the beneficiaries are known only to the testator and the appointed trustee. This is known as a 'secret trust'. Secret trusts operate independently of the statutory formalities for testamentary dispositions and thus may be valid even though they are not referred to in the will.[47] The person alleging the secret trust's existence need only prove on the balance of probabilities that it does so exist.[48] In the family trust context, this might arise where a parent (the testator) wishes to benefit a child who is born outside of wedlock or a particular religious, political or other cause with which they privately concerned themselves.

1.4. Trusts vs. Other Forms of Legal Relationship

Trusts bear similarity to other forms of legal concepts and it is important beyond mere academic interest that the differences between each be understood. The legal and practical consequences that attach to each vary greatly.

[44] See 1.2.2 for a more detailed explanation of the settlor's role in trusts.
[45] *Wills Act 1968* (ACT), s 9; *Succession Act 2006* (NSW), s 6; *Wills Act 2000* (NT), s 8; *Succession Act 1981* (Qld), s 10; *Wills Act 1936* (SA), s 8; *Wills Act 2008* (Tas), s 8; *Wills Act 1997* (Vic), s 7; *Wills Act 1970* (WA), s 8.
[46] One notable exception is in the case of sole proprietorships, in which case the proprietor's business has no separate legal identity and thus dies when the proprietor does. Partnerships which are informal and not recorded in an official partnership agreement can also dissolve upon the death of one of the partners, however an appropriately drafted partnership agreement can easily avoid this consequence and ensure the deceased partner's share in the business is transferred or absorbed.
[47] *Blackwell v Blackwell* [1929] AC 318.
[48] *Howell v Hyde* (2003) 47 ACSR 230.

1.4.1. Agency

Agency describes the relationship between one party (the principal) and another party (the agent) in which the principal designates authority to the agent to act on the principal's behalf. The agent is authorised to create and affect legal relations between the principal and third parties. The existence of agency is determined by reference to any documentation expressly creating the relationship or otherwise through implication by analysis of the circumstances. In much the same way as an agent acts in the best interests of their principal, a trustee acts in the best interests of a beneficiary. However, unlike with trusts, an agent need not assume legal title over the principal's property during the life of the agency. Moreover, an agent acts with the express or ostensible authority of their principal, whereas a trustee acts in accordance with the trust's instructions and not, with very limited exceptions, at the direction of the beneficiaries.

1.4.2. Bailment

Bailment occurs where a person (the 'bailor') delivers goods they own to another person (the 'bailee') upon an express or implied promise that the goods will be returned to the bailor or dealt with in a particular manner. The model example of bailment is the delivery of one's car to a mechanic for service or repair. The mechanic has possession of your property and authority to make specified modifications to it, but must then return it to the owner who retains legal title in the property. Trustees similarly hold property on behalf of another and owe certain duties in respect of that property. However, unlike with bailees, trustees attain both possession *and* legal title to the property in question and can legally dispose of it. Moreover, bailments can only involve personal property whereas a trust may, and often does, involve both real and personal property. A final important distinction between the concepts of trust and bailment is that a beneficiary's rights under trust vary greatly from a bailor's rights at common law.

1.4.3. Contract

A contract is an agreement voluntarily entered into between two or more parties which, pending the satisfaction of common law (and in some cases statutory) requirements, the law enforces. A contract might well involve a person holding property for the benefit of another, which may resemble the manner in which a trustee holds trust property for beneficiaries. However, unlike contracts which are created through mutual agreement, trusts are established by a settlor in accordance with his or her express wishes. As explained at 1.2.6, variation of a trust deed can be a complicated exercise and must follow the procedures stipulated in the trust deed whereas, in most cases, contracts can be varied by simple agreement.

Other points of distinction lie in the methods of establishment and the consequences of breach. Unlike with contracts, no consideration is necessary to support the creation of a trust. A party who breaches a contract is liable to pay damages in an amount which will revert the innocent party to the position they would have been in but for the breach. Additional rules of causation, foreseeability and remoteness help shape the amount of compensation payable. Conversely, a trustee who commits a breach of trust must restore the trust to its pre-breach position. The rules of contract damages do not readily enter into the equation.[49] A trustee who breaches trust may also be required to repossess trust property or undertake other actions, as opposed to the law of contract which would merely require them to pay damages to the innocent party equivalent to the loss that party incurred through the breach.

1.4.4. Debt

Where a person (the debtor) owes a sum of money to another (the creditor), a relationship of debt arises. This relationship is all too familiar to the commercial world. It is not normally the case that a debtor is also a trustee for their creditor. Debts are normally secured by securities over other assets. The security can only be called in by the creditor upon the debtor's default. On the other hand, a beneficiary who is of legal age and fully entitled may seek to have the trust property transferred to them at any given time. The crucial distinction between trusts and debt can be seen most clearly through insolvency proceedings. Section 116(2)(a) of the *Bankruptcy Act 1966* (Cth) stipulates that where a trustee declares bankruptcy, the property it holds on trust for others is not subject to creditors' claims.

[49] *Re Dawson (deceased)* [1966] 2 NSWR 211.

2. The Legal Framework for Family Trusts

2.1. Introduction

The Australian legal framework for family trusts is a patchwork of common law (equity) and statutory rules developed and refined over centuries. Both sources of law have played a crucial role in shaping the manner in which trusts can be created, administered and terminated. A comprehensive discussion of all aspects of this legal framework is beyond the scope of this report. However, some key aspects are addressed below.

2.2 Case Law Governing Trusts

The courts have traditionally been the most significant source of law concerning trusts. This is for two reasons: first, as discussed earlier,[50] the trust is a creature of the law of equity, which derives from the old and highly influential English Court of Chancery (developed in 1474); second, the Australian legislation governing trusts has codified many – perhaps most – case law principles pertaining to trusts. Of course, many changes and new principles have also been brought about by legislative intervention. The relationship between the common law and statute in the field of trusts is somewhat symbiotic, with the majority of statutory intervention being inspired by novel uses of trusts. As former High Court Chief Justice Robert French has noted extrajudicially:

> It would not be right to say that the general regulatory statutes in Australia have altered the essential content of the law of trusts or the concept of a trust. There is no doubt, however, that in Australia there have been developments in the use of the trust concept in ways never contemplated when the equitable doctrines described broadly as the law of trusts were developed.[51]

Nonetheless, the decisions of the courts remain as significant to the law of trusts today as they did hundreds of years ago. Perhaps the best and most relevant example of this significance arises in respect of the formation of trusts. The case law is responsible for establishing the 'three certainties' in the general law of trusts.[52] These certainties still form the basis of the law of trusts in modern times and warrant discussion in this report and any consideration of trusts and how they operate in contemporary society. Any express trust, however created, must be certain as to: (1) intention; (2) subject matter; and (3) object.

A settlor intending to establish a trust must, either expressly or by implication, indicate their intention to do so. The courts consider the general circumstances, the language utilised by the settlor, and the trust instrument (if any) to deduce the existence of certain intent and the scope of the trust's rules. If no such intention can be affirmatively proven on ordinary construction of the words used by the settlor, the transfer may be interpreted as a gift, or otherwise a resulting trust arises vesting the appointed trustee(s) with responsibility to hold the property on trust for

[50] See 1.1.
[51] Chief Justice Robert French, 'Trusts and Statutes' (2015) 39 *Melbourne University Law Review* 629, 643.
[52] *Knight v Knight* (1840) 3 Beav 148; 49 ER 58.

the settlor. In family trust settings, the settlor invariably draws up a trust deed *inter vivos*, or otherwise establishes a trust through his or her will.

If certain intent can be established, the subject matter of the trust must then be conclusively identified, or at least, capable of identification. As mentioned earlier in section 1.2.5, trust property can be just about anything: personal property, real estate, intangible rights (e.g. intellectual property rights), choses in action (e.g. the right to recover a debt), the list goes on. What is critical is that there be certainty as to an actual beneficial interest which the beneficiaries can enjoy, which is why property that does not yet exist cannot be the subject of a trust. While there is typically an express indication of trust property in trust deeds or as otherwise declared by the settlor, a reasonably precise method or list of criteria by which trust property can be identified will normally suffice to meet the threshold of certainty.[53]

Framing this in the context of family trusts once again, the trust property will normally be in the nature of family property (residential housing, family heirlooms or other personal possessions, and the like). Given the growing popularity of using trusts as a vehicle for commercial activity, it is also the case that family businesses often become the subject of a trust. Settlors – often parents – see the family business trust as a tool of investment, ideally providing a reliable source of income, an appreciating asset, and a means by which the family legacy can be carried on in physical form.

Finally, the 'object(s)' of the trust must be certain. This is sometimes termed the 'beneficiary principle' and logically requires that the intended beneficiaries (or charitable purposes) of a trust be clearly ascertained or at least capable of identification. 'There must be somebody, in whose favour the Court can decree performance'.[54] The threshold for certainty differs depending upon the type of trust. For fixed trusts, there must be 'list certainty'; at the date of distribution, it must be possible for a list of all identifiable beneficiaries to be compiled. In the case of discretionary trusts, the trustee has discretion to make distributions to any members of a particular class of beneficiaries. As such, the threshold for certainty is slightly lower: it need only be established whether a particular object falls into the particular description of the relevant class or not. This is frequently termed 'criterion certainty'.

In the discretionary family trust context, where the trust comprises or represents an aspect of the family business, the settlor will often vest the trustees with the power to make distributions to his or her descendants working within, or having a mere interest in, the family business. Normally the settlor will either refer to family members and descendants in the definitions and operative clauses of the trust deed, or otherwise make a generic reference to the 'employees' of the family business where it is entirely family owned and operated. The trustee, unless otherwise restricted by the terms of the trust deed or the common law, will then possess the power to make distributions to any or all of the members of the class of beneficiaries in any amount they see fit.

---

[53] *Re Golay's Will Trusts* [1965] 1 WLR 969.
[54] *Morice v Bishop of Durham* (1804) 9 Ves 399, 404-5.

As discussed throughout this report, the case law also informs a number of important aspects of trusts. In particular, the powers and duties of the parties and the manner in which trusts can be utilised and brought to an end have been exhaustively discussed in the courts of England and Australia. Importantly, as will be discussed later in this report, the courts have also been required, particularly in modern times, to consider how the various taxation laws impact upon trusts.

2.3 Statute Law Governing Trusts

There are many statutes which either directly or indirectly impact upon trusts. In terms of governance, it can be said once again that the case law has as important a role in the field of trusts as the statutory law does. Canvassing the myriad of ways in which the relevant statutes govern trusts is beyond scope. However, some notable statutes and their general effect should be noted.

2.3.1. Trustees Acts

The Trustees Acts in each Australian state and territory naturally play a significant role in the area of trusts.[55] The general purpose of each statute is to amend and consolidate the law relating to trustees and trust property. Some also directly impact upon the law of wills and estates and have prompted changes to other Acts as a consequence. As with all laws, the law of Parliament is supreme and takes precedence over the common law. As such, when considering the governance framework for trusts, statute must be the first port of call.

2.3.2. Taxation Acts

As will be discussed later in this report, the various taxation laws also directly impact upon the law of trusts, certainly in respect of trusts which draw income for their beneficiaries. As trusts are often used for business purposes in modern times, particularly by virtue of the tax benefits this strategy attracts, many taxation laws have been moulded accordingly to ensure that trusts and the parties to them are appropriately taxed. The *Income Tax Assessment Act 1936* (Cth), in particular, is of pertinence to trusts insofar as they operate as a source of taxable income for their beneficiaries.

2.3.3. Property Law Acts

As mentioned earlier, at 1.2.6, the law of equity is concerned more with the intent of the party seeking to benefit another out of specified property through a trust than with the form of this arrangement. Accordingly, there is no common law requirement for valid *inter vivos* trusts to be created by writing. A 'declaration' of trust or 'transfer' of

[55] *Trustee Act 1925* (ACT); *Trustee Act 1925* (NSW); *Trustee Act 1893* (NT); *Trusts Act 1973* (Qld); *Trustee Act 1936* (SA); *Trustee Act 1898* (Tas); *Trustee Act 1958* (Vic); *Trustees Act 1962* (WA).

legal title is all that is required. That said, as discussed at 1.2.6, certain forms of trust are subject to statutory rules under the various Property Law Acts in each state and territory.[56] One such rule pertains to transfers of interest in land (into trust or otherwise); such dispositions must be recorded in writing.

2.3.4. Wills Acts

As mentioned earlier, at 1.3.6, testamentary trusts established through a will must naturally accord with the various wills and succession Acts in each Australian jurisdiction. If the requirements to establish a valid will are met, a trust can be established at the passing of the testator. The requirements for validity are generally the same throughout the states and territories.[57] The will must be in writing, signed by the testator (or a lawful representative acting under the testator's direction) at the end of the document, and signed by two or more witnesses who attest to the will in the testator's presence.

2.3.5. State based Trust Vesting Legislation

Trust vesting is discussed in greater depth at 5.8. For present purposes, it suffices to say that legislation in some jurisdictions impacts, to differing extents, upon the common law 'rule against perpetuities'. As will be explained later in the report, the rule was developed as a means of limiting the life of a trust and ensuring property within it was not retained for an excessively long period of time. As the Queensland Law Reform Commission noted in a report into the law relating to perpetuities and accumulations, the rule 'performs a useful social function in limiting the power of members of generations past from tying up property in such a form as to prevent its being freely disposed of in the present or the future'.[58]

Perpetual vesting of trust property prevents the property from being alienated (sold or transferred) for an unduly long time. This can have implications for family trusts in particular. As Evans explains:

> If property is settled on successive life tenants for several generations, there will not be anyone, until the expiry of all those generations, free to alienate the entire estate in the property subject to the gift. Not only that, but, down the chain, interests will vest in favour of, for example, the first grantee's grandson or great-grandson at some remote time in the future.[59]

---

[56] *Civil Law (Property) Act 2006* (ACT); *Conveyancing Act 1919* (NSW); *Law of Property Act 2000* (NT); *Property Law Act 1974* (Qld); *Law of Property Act 1936* (SA); *Conveyancing and Law of Property Act 1884* (Tas); *Property Law Act 1958* (Vic); *Property Law Act 1969* (WA).
[57] *Wills Act 1968* (ACT), s 9; *Succession Act 2006* (NSW), s 6; *Wills Act 2000* (NT), s 8; *Succession Act 1981* (Qld), s 10; *Wills Act 1936* (SA), s 8; *Wills Act 2008* (Tas), s 8; *Wills Act 1997* (Vic), s 7; *Wills Act 1970* (WA), s 8.
[58] Queensland Law Reform Commission, *A Report of the Law Reform Commission on the Law Relating to Perpetuities and Accumulations* (24 May 1971) cited in *Nemesis Australia Pty Ltd v Commissioner of Taxation* (2005) 150 FCR 152, 158.
[59] Michael Evans, Bradley L Jones and Theresa M Power, *Equity and Trusts* (LexisNexis, 4th ed, 2016) p 487.

While the rule no longer applies in South Australia, it has been replaced by statute with a fixed vesting period of 80 years in New South Wales[60] and the Australian Capital Territory.[61] In Queensland, Victoria and Tasmania, a settlor can elect a vesting period of up to 80 years.[62] The Northern Territory legislation is worded slightly differently and provides that the vesting period can be either 21 years or 80 years, as stipulated in the trust instrument.[63]

2.3.6 Other Legislation

There are many other pieces of legislation which may impact upon a trust. These will normally arise by virtue of how the trust operates. For example, if a corporation is designated trustee for a trust, the directors of the corporation are liable both to the beneficiaries of the trust under the common law and Trustees Acts, and to their members/shareholders under the *Corporations Act 2001* (Cth). Again, the number of Acts which might impact upon trusts are too many to number and discuss in this report. However, it is absolutely prudent for parties intending to establish a trust, or who have established a trust and seek to carry out a particular function the permissibility or effect of which is unclear, to seek appropriate professional legal and financial advice to ensure that no laws are inadvertently breached or unwanted liability is assumed.

2.4 A Typical Family Trust Deed

A typical family trust deed, an example of which is included as Appendix 1 to this report, will include a number of important provisions which cumulatively help establish and define the rules for the proper administration of the trust. Among the standard inclusions are the following:

1. Name of the family trust;
2. Definitions for specific terms utilised throughout the deed;
3. Identification of the parties (described earlier at 1.2.1-1.2.4) including:
    a. Settlor;
    b. Appointor;
    c. Beneficiaries;
    d. Trustee;
4. Trustee duties and powers;
5. Variation clause;
6. Applicable vesting (perpetuity) period; and
7. Governing law.

---

60 *Perpetuities Act 1984* (NSW), s 7.
61 *Perpetuities and Accumulations Act 1985* (ACT), s 8.
62 *Property Law Act 1974* (Qld), s 209; *Perpetuities and Accumulations Act 1968* (Vic), s 5; *Perpetuities and Accumulations Act 1992* (Tas), s 6; *Property Law Act 1969* (WA), s 101.
63 *Law of Property Act 2000* (NT), s 187.

3. The Family Trust as a Business Structure

3.1 Introduction

The previous two parts of this report have provided an overview of the nature and use of a family trust and the legal framework that determines how family trusts are created, administered and terminated. In Australia, alongside trusts, businesses generally trade through one of three other common legal structures, namely: sole proprietorship, partnership, or company. In this part, the main issues that influence the choice of legal structure for a business are summarised and, in particular, why a family may choose to operate a business through a trust structure. Although prior research suggests that around one in five Australian businesses are operated through a discretionary trust,[64] the general incidence of the *use* of trusts is much higher given they are often used in conjunction with other legal entities such as company structures. In this part, the four most commonly used business structures that involve a combination of different entities are discussed, along with the reasons why families may choose to use such arrangements.

3.2 Prevalence of Family Trusts as Business Structures versus Other Common Business Structures

Australian businesses operate using one of four common legal structures, namely, sole proprietor, partnerships, companies or trusts (or a combination thereof). As highlighted in Table 1, the most common legal structure used by Australian businesses operating in the private sector (i.e. non-government entities) is a company structure, representing 38 percent of all businesses in 2018. Although 24 percent of all Australian businesses are operated through trusts, this includes all types of trusts such as unit trusts and discretionary trusts. Most family businesses operated through trusts utilise discretionary trusts. Based on the biennial KPMG-Family Business Australia National Family Business Surveys undertaken by the University of Adelaide Business School since 2013, the number of family-owned businesses operated through trusts ranges from 15 to 22 percent.[65] Therefore, it can confidently be said that most businesses operated through trusts are discretionary trusts.

---

[64] Although Table 1 suggests around 1 in 4 businesses are operated through trusts (which includes all types of trusts such as unit trusts and discretionary trusts), based on the biennial KPMG Australia – Family Business Australia National Family Business Survey, around 1 in 5 family businesses are operated through a *discretionary* family trust.

[65] C Graves, F Barbera and J Thomas, *KPMG-Family Business Australia 2017/2018 Australian Family Business Survey* (2018), The University of Adelaide, South Australia.

Table 1: Breakdown of Australian Businesses by Legal Structure[66]

	2014/15	%	2015/16	%	2016/17	%	2017/18	%	Survival rate (2014 to 2018)
Private Sector									
Sole Proprietors	549,833	26%	561,027	26%	586,547	26%	629,388	27%	56%
Total Partnerships	287,320	14%	276,303	13%	267,443	12%	257,213	11%	65%
Total Companies	770,574	36%	804,197	37%	839,502	38%	870,064	38%	66%
Trusts	513,014	24%	529,606	24%	544,414	24%	556,251	24%	72%
Total businesses	2,120,741	100%	2,171,133	100%	2,237,906	100%	2,312,916	100%	65%

Businesses operated through trusts have the highest survival rate[67] when compared to other company structures. As highlighted in Table 1, 72 percent of the businesses operating through trusts in 2014 were still operating in 2018. This compares with 56 percent for sole proprietors, 65 percent for partnerships and 66 percent for companies. However, these statistics should be interpreted with caution. Based on data collected from the roundtable sessions as part of this report, the superior survival rate of businesses operated through trusts may be due to composition of business assets operated through trust structures (i.e. property investments).

It is important to highlight that the figures presented in Table 1 reflect the legal structures utilised by the entity operating the business. In reality, when owners (particularly family businesses) are establishing a structure for their business, there is often more than one legal entity involved. As highlighted in Diagrams 2, 3 and 4, family trusts are often utilised in conjunction with other legal structures, particularly company structures. For example, the operating business may be set up as a company, however, the company shares are owned by a trust (or several trusts) as depicted in Diagrams 2, 3, and 4. As a consequence, although 24 percent of all Australian businesses are operated through trusts, their rate of use will be much higher than this due to being utilised in conjunction with other legal entities. Any changes to rules surrounding use of trusts will have an effect on more than 24 percent of businesses operated through trusts.

[66] Data extracted from the Australian Bureau of Statistics (ABS) 8165.0 - Counts of Australian Businesses, including Entries and Exits, June 2014 to June 2018. Note – this ABS database does not include all businesses operating in Australia. For example, it only includes those businesses that have an Australian Business Number (ABN) and are actively trading in the provision of goods and services. For more information, refer to https://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/8165.0Explanatory%20Notes1June%202014%20to%20June%202018?OpenDocument.

[67] A business exit is where the ABN or GST role of a business has been cancelled and/or where a business ceased to remit GST for at least five consecutive quarters.

In summary, a significant proportion of businesses utilise trusts structures, both directly and indirectly. Family discretionary trusts are the most common form used and there is some evidence to suggest that businesses operated through a trust structure have a superior survival rate compared to other legal structures.

There are a number of benefits associated with utilising a company structure, which is why a company structure is a common business structure as well as a common element in an overall business structure (as discussed above). The advisers at the roundtables noted the following taxation benefits of using a company rather than a trust structure:

- the ability to use franking credits;
- a reduced tax rate compared to the trustee rate;
- potentially less Div. 7A issues;
- the ability to retain earnings without paying tax at the top marginal tax rate; and
- the ability to access certain R&D concessions.[68]

A number of commercial benefits were also identified. For example, a company structure was said to be simple to understand, easier for a purchaser to acquire, and a useful mechanism for asset protection.

When the business structure includes a combination of a company and trust, as is most commonly the case (discussed above and represented in Diagrams 2-4), the benefits of both companies and trusts can then be maximised within the one business structure.

The prevailing view of the advisers at the roundtable sessions was that the use of family trusts as a trading entity will continue to decline in popularity, but that trusts will continue to be used in the overall business structure (as in Diagrams 2-4) as well as for a number of other reasons in the future. It was the consensus that companies have started to become more popular since 2009, post the Commissioner's change of approach to Div. 7A and UPEs which has created problems with retaining profits in a family trust (discussed later at 5.5). Much of this roundtable discussion, however was based around the uncertainty surrounding tax issues in light of the then proposed tax reform policies of the Australian Labor Party, which would have adversely impacted on trusts. These reforms included the reduction in the CGT discount from 50% to 25%, changes to franking credits, and a proposed 30% trust distribution tax.

All of these proposed, and now defunct, reforms were highlighted as issues that legal and accountants were paying close attention to. It was noted that trends are making trusts less attractive. One adviser noted a recent example where they advised a client to put appreciating assets in a company based on modelling that showed it would be more tax effective than a trust, which was against the common practice of previous years.

[68] On R&D concessions, see 5.10.

In contrast, there were a number of tax advisers in the second roundtable who predicted that the popularity of the family trust would remain the same or increase due to its benefits of flexibility and in estate planning.

The roundtable discussion surrounding the use of partnerships concluded that their use is currently uncommon – save for in the context of a professional practice, which would usually be a partnership of trusts or unit trusts. There are still partnerships on foot which were set up a long time ago, especially in rural businesses.

Another issue that was highlighted was the use of 'hybrid' structures, being a company with multiple classes of shares or a discretionary unit trust. One adviser noted that 'hybrids' cause a problem when trying to apply the tax legislation to them (not only income tax but also stamp duty). For example, when trying to access the small business CGT concessions.[69]

The advisers noted they would not recommend a family trust business structure for unrelated parties due to imposition of family trust distribution tax applicable to the streaming of income of the trust outside of the 'family group' in cases where the trust has made a Family Trust Election (FTE) (discussed at 5.8). It was also noted by one adviser that if the relevant business seeks to trade internationally, they will likely have to trade through a company, as trusts are not well understood overseas and complicate matters.

3.3 What Influences the Choice of Business Structure?

The advisers at the roundtable sessions identified the following main factors as influencing the choice of business structure adopted by families:

- ability to raise capital;
- limitation of liability;
- exit plan;
- succession planning;
- taxation;
- access to grants and concessions – for example for R&D (see 5.11);
- ability to introduce new investors;
- how third parties treat the business structure (for example, lenders and potential investors);
- the desire to create a vehicle for long term family wealth creation; and
- whether the business may trade internationally.

The consensus view at both roundtables was that minimisation of tax is often the most important factor when determining the structure of a family business, however the other factors are also important. Family trusts were

[69] See Part 4.

described as being an important vehicle for long term family wealth creation as they enable families to pool their resources and manage tax liabilities from a family unit perspective. It was noted that the gap is narrowing regarding the tax benefits of family trusts versus other business structures. In both roundtables it was agreed that even if family trusts provided no additional tax benefits over companies and other structures, that there would always be other benefits that drive the use of family trusts. For example, advisers agreed they would still be utilised in business structuring due to their flexible nature which is particularly important when estate planning and controlling the distribution of income. It was agreed that this would be the case even if trusts were to lose all tax benefits.

It was agreed that it is part of the adviser's role is to advise clients that their circumstances may change, and that flexibility should be encouraged. The advisers also highlighted the difficulty in advising clients while areas of tax law may be subject to reform.[70]

It was also noted that cost is a critical factor in determining the structure through which a business is carried out in. It may be that the 'ideal' structure is not used due to cost. For example, one adviser noted that a business may start as a partnership because the start-up costs are almost zero.

With respect to the complexity of a trust structure relative to basic structures such as a sole proprietorship or partnership structure, advisers at the roundtable sessions noted that different clients have different levels of sophistication. It was said that, often, simplicity of structure is important for the client and that clients want a simple structure that they can understand. However, other clients may be happy to hand responsibility to the adviser to take care of the structuring and operations from a legal and financial perspective. One adviser mentioned that the client looks to their adviser to make decisions and that a constant education process with the client is necessary (with respect to their rights and obligations, making resolutions etc.).

It was highlighted that there is a distinction between the roles of a lawyer and an accountant. It was noted that it may be that the lawyer assists the client to set up the business structure and then have little interaction with the client after this. On the other hand, the client may have a great deal of dependence on their accountant to administer and look after their business structure and relevant lodgements once the business is established.

3.4 Common Business Structures Involving Family Trusts

As mentioned above at 1.1, a family trust is typically a discretionary trust established for the purpose of holding a family's assets or conducting a family business. More often than not, the trustee(s) will be one or more members of the family group, as will the beneficiaries. The manner in which family trusts operating as businesses are structured varies greatly, as will be discussed shortly.

[70] For example, changing the CGT discount from 50% to 25%, Division 7A and the use of franking credits. Of course, the Australian Labor Party's proposed reforms are no longer an immediate concern due to its defeat at the 2019 federal election. That being said, the Morrison Government and the Australian Taxation Office have not ruled out other measures of reform.

The advisers at the roundtable sessions identified the following primary reasons as to why a business may be structured through a family trust:

- Greater flexibility in tax planning compared to other business structures;
- The ability to maintain the commercial and asset protection advantages afforded by companies;[71] and
- The flexibility in estate planning.

Each of these benefits is discussed in detail in Part 4 of this report. In general terms, the advisers discussed the following four main structures as being most common with their small business and family enterprise clients:

a. Trading (family) trust distributing funds to family beneficiaries and a bucket company (Diagram 1 below);[72]
b. Trading company owned by family trust, with the trust distributing funds to family beneficiaries (and possibly a bucket company) (Diagram 2 below);
c. Trading company owned by family trust, with the trust holding and licencing its assets to the trading company for commercial use and distributing funds to family beneficiaries (and possibly a bucket company) (Diagram 3 below);
d. Trading company owned by family trust, with an asset company (also owned by family trust and holding goodwill, valuable property, plant and equipment, and retained profits) licencing its assets to the trading company for commercial use (Diagram 4 below).

As will be seen, the most common family business structure involves a combination of different legal entities, including both companies and trusts.

The most basic business structure involving a family trust is where a trading (family) trust distributes funds to family beneficiaries and a bucket company (Diagram 1):

[71] With respect to family law, it was stated that the prevailing view is that 'nothing is really protected any more', including family trusts.
[72] A bucket company describes a company established to receive distributions from a discretionary trust so as to ensure that the trust's income is taxed at the flat company taxation rate of 30%. The trustee will first distribute trust income to the family members (beneficiaries), who will pay tax on their earnings at the relevant individual marginal tax rate (unless they are minors or non-residents, in which case the trustee will pay the tax on their behalf based upon their share of the trust's net income). Any residual income will then be distributed to the bucket company to avoid it being taxed at a much higher rate.

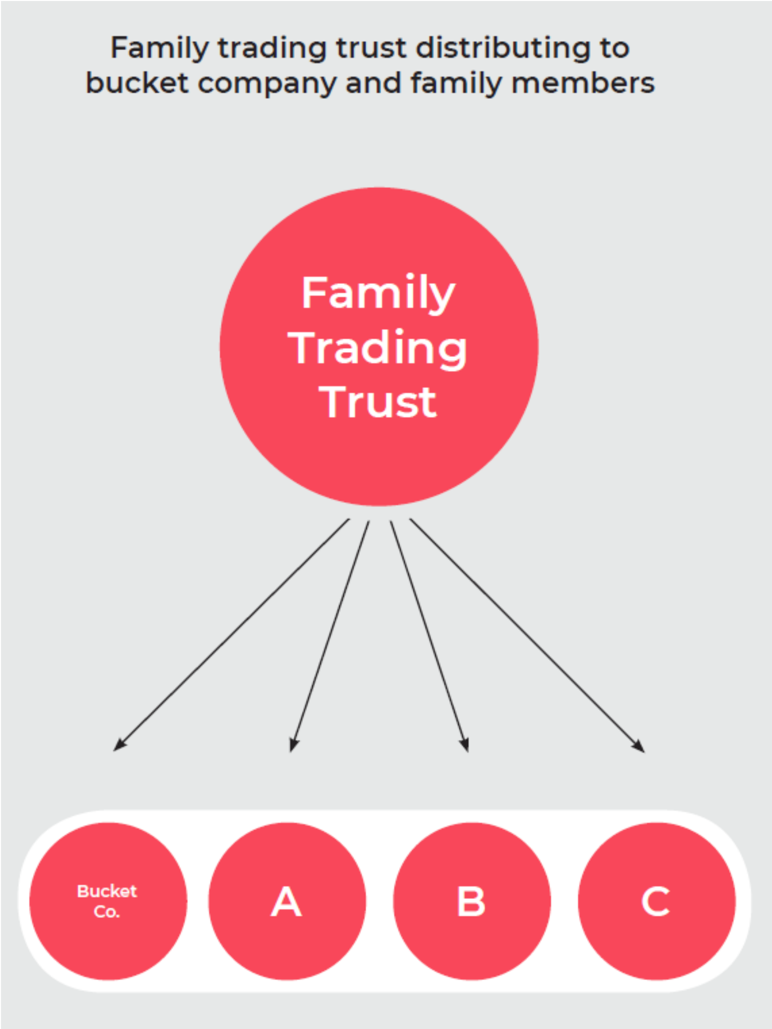


Diagram 1: Family trading trust distributing to family beneficiaries and a bucket company

While a basic family trust such as that represented in Diagram 1 is a common type of business structure, it was agreed by the advisers at the roundtable sessions that family trusts are not commonly used as the head trading entity in a business structure. The advisers considered that the most common business structure involves a combination of different entities, including companies and family trusts. Combining the structures can have the following advantages over using a family trust as the head trading entity:

- Avoids restrictions upon the ability to raise capital;
- Allows the introduction of new investors;
- Can maintain the benefit of the CGT discount;
- Provides greater asset protection;
- Provides access to working capital at a 30% tax rate without the complex UPE issues;
- Enables easier exit;
- Provides access to R&D tax concessions.

Each of these points is discussed in detail later in this report.

One combination is that a where trading company is owned by a family trust, with the trust distributing funds to family beneficiaries (and possibly a bucket company), as shown below in Diagram 2:

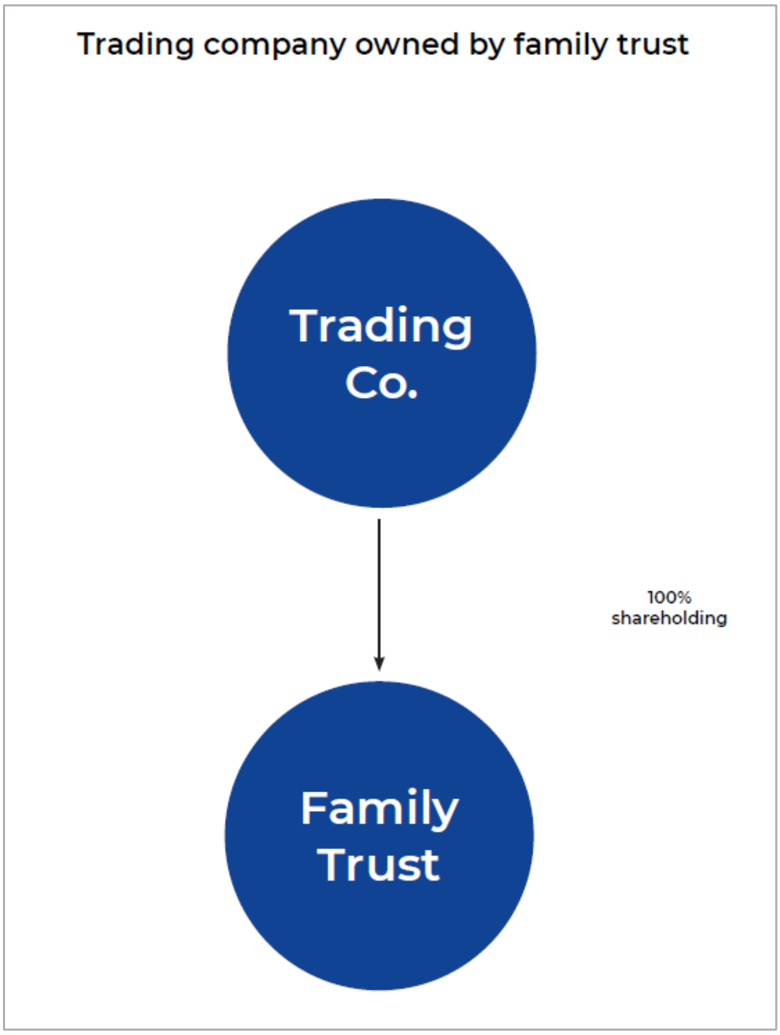


Diagram 2: Trading company owned by family trust

Another typical basic structure, as depicted in Diagram 3 below, would be a company carrying on the business and the assets associated with the business (land, plant and equipment) being held in a discretionary trust. The position was summarised by one adviser in the following terms: ‘Trusts are Plan A for equity, companies are Plan A for the business’.

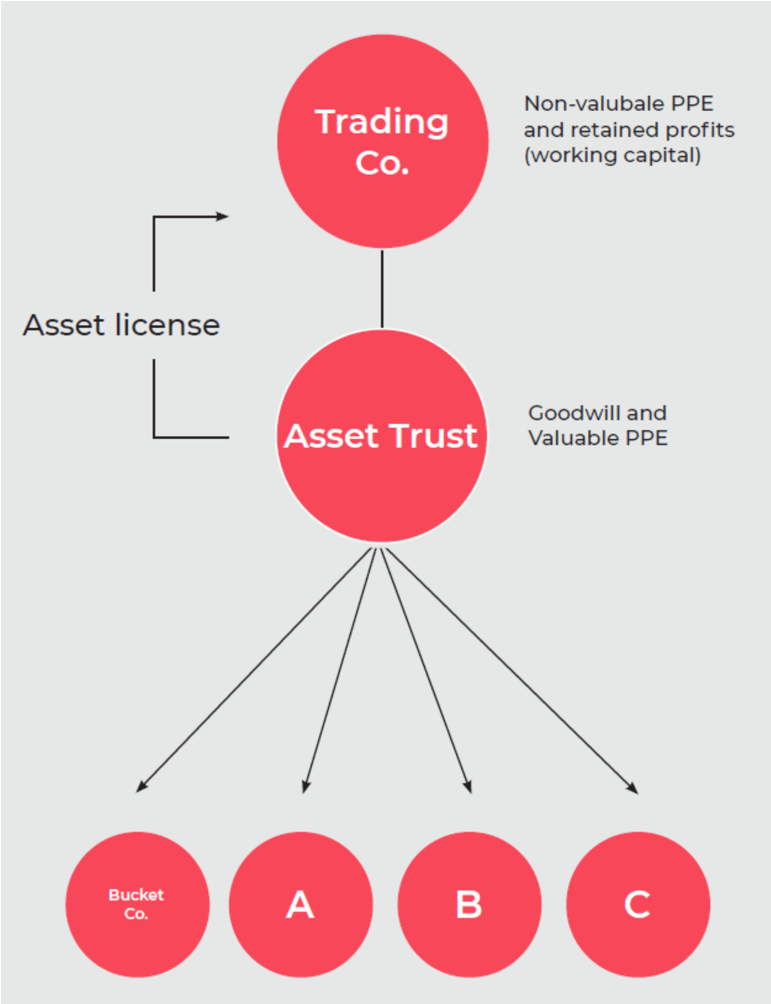


Diagram 3: Trading company owned by asset-holding family trust

The fourth structure, represented in Diagram 4 below, is similar to that represented in Diagram 3, but rather than the trading company being owned by a family trust, it is instead owned by an asset holding company that is owned by a family trust.

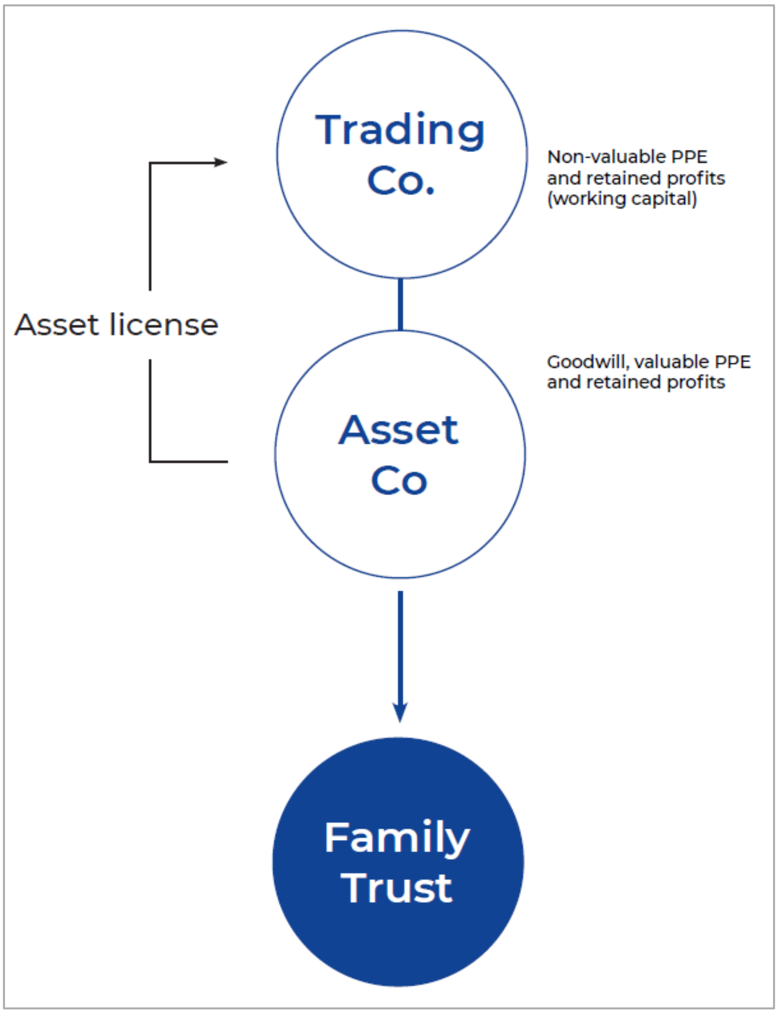


Diagram 4: Trading company owned by asset-holding company (which is owned by a family trust)

The advisers in the second roundtable were provided with a handout of various combinations of business structures (refer to Appendix 5) involving trusts and companies and asked to identify which structures were most common in their practice. The advisers agreed that the most common structures to use are (2) and (4), whereas (3) may be used to hold land or other appreciating capital assets.

One adviser noted that structures (2) and (4) are easy to sell as companies, whereas other structures would require an asset sale, which is more complicated. Number (4) was generally preferred over (3) where the facts were applicable due to its 'flat' structure – but this would depend on nature of the assets held by the taxpayer. A couple of the advisers commented that they often propose the use of structure (1); however, when there is the prospect of bringing in new investors, the most common structure would then be (4).

4. Benefits of Carrying on a Business through a Family Trust

4.1. Introduction

As mentioned earlier, there are a number of benefits to carrying on a business through a family trust or including a family trust as part of an overall business structure (rather than utilising a company or other structure). These benefits relate to the favourable tax treatment of family trusts, the asset protection advantages of family trusts, the greater flexibility they provide, and a number of non-economic drivers.

4.2. Taxation Benefits of a Family Trust

The way that business owners perceive it, the more tax paid, the less working capital for the business. Accordingly, the tax advantages of family trusts are considered to be a principal motive for operating through a trust structure or for incorporating a trust as part of the overall business structure.

The rules in Division 6, Part III of the *Income Tax Assessment Act 1936* (Cth) ('ITAA 1936') govern the taxation of income of family trading trusts. The general capital gains tax (CGT) rules in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997') govern the taxation of capital gains made through the disposal of business assets held in a trust.

There are several taxation benefits that flow from operating a business through a family trust. For example, the owners of the business can 'split' the income of the trust between family members or to a corporate beneficiary so that the family group can benefit from an overall reduced tax liability. This is not available to companies or other entities. The owners of the business can also 'stream' the income of the trust between family members or to a corporate beneficiary. This option is also unavailable to companies or other entities.

Operating a business through a family trust also allows access to the 50% CGT discount made on the sale of whole or part of the business after 12 months.[73] This is not available to companies, but is available to individuals and superannuation funds. Finally, it also allows the owners to access the CGT 'small business concessions' which can potentially eliminate any CGT payable on the sale of whole or part of the business.[74]

Each of these benefits will now be discussed further.

[73] Division 115, ITAA 1997.
[74] Division 152, ITAA 1997.

4.2.1. Income Splitting

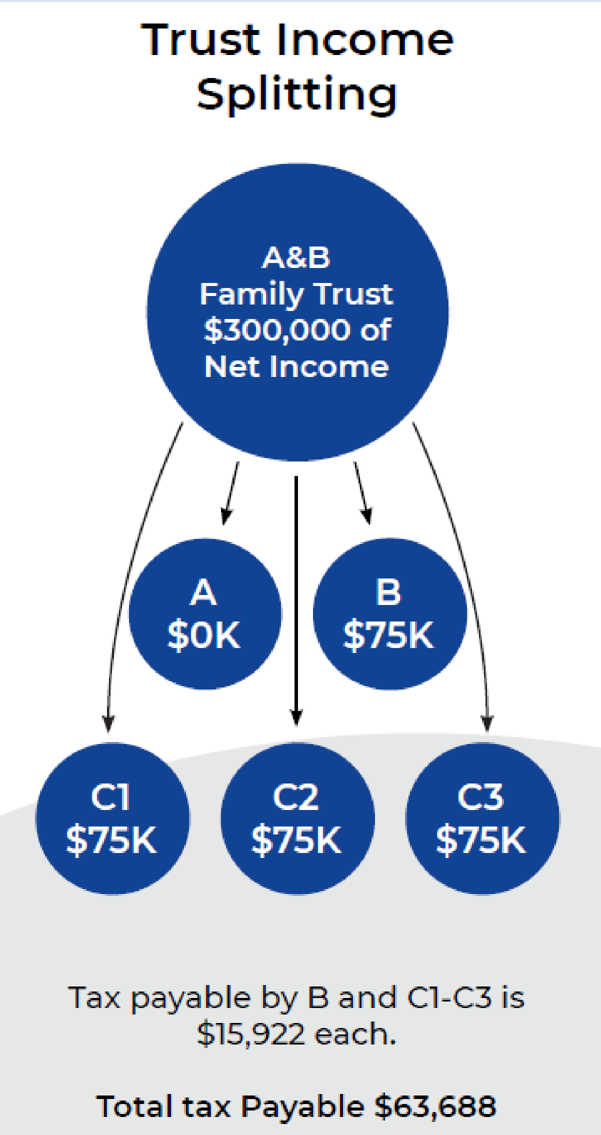
Trusts are largely taxed on a flow-through basis with the income of the trust allocated to beneficiaries who are taxed on their share of the trust income at their marginal tax rate. Provided the trust deed allows it, being a discretionary trust, the trustee has a discretion (the flexibility) to distribute income or capital to any of the beneficiaries of the trust. Companies and other entities are unable to split income in this way to benefit from a reduced overall family group tax liability. The proportion of income distributed to each beneficiary is at the discretion of the trustee and could vary from year to year providing flexibility.

Example – Trust Income Splitting versus Employees versus Company Dividend Distribution

Trust Income Splitting

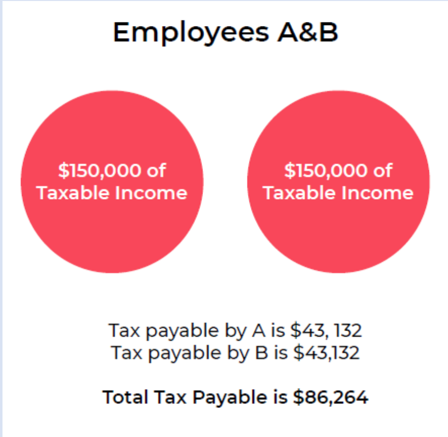
The A&B Family Trust is an Australian resident trust that has net income of $300,000 at the end of the income year. The beneficiaries of the trust are Mr A, Mrs B and their three children C1, C2 and C3. Mrs B is not working and C1, C2 and C3 are all university students aged over 18 and also not in receipt of any income. Mr A holds a number of investments outside of the trust which generate income of over $180,000 during the income year.

Given this set of facts, in order to minimise the family groups tax liability, the trustee of the trust would not distribute any of the net income of the trust to Mr. A as he is already on the top marginal tax rate, instead all income will be districted equally to Mrs B and her three children. This will result in tax payable of $63,688[1] on the $300,000 of net income of the trust.



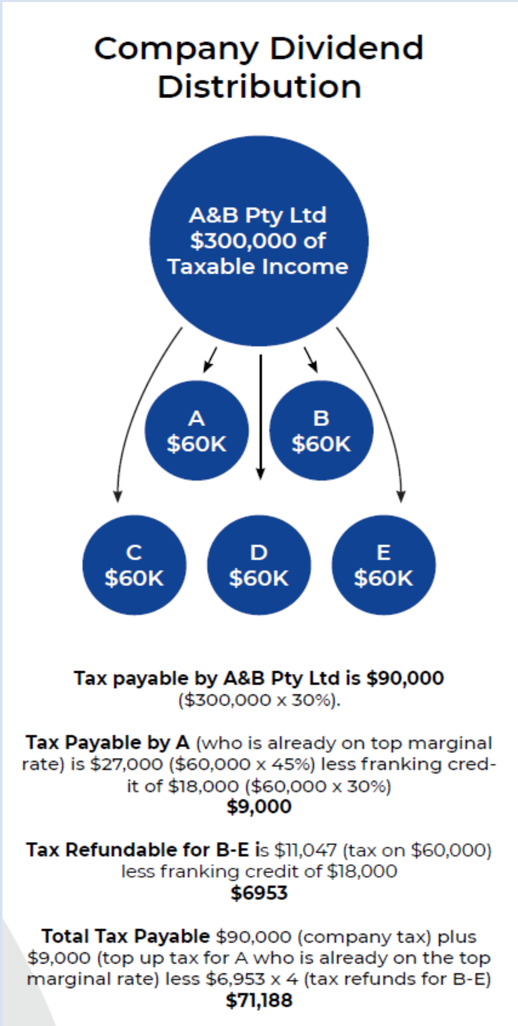
Example – Trust Income Splitting versus Employees versus Company Dividend Distribution

Mr A and Mrs B are employees each earning $150,000 during the financial year. Assuming this is their only source of income and no deductions are allowable, their tax liability will be $43,132 each. Their total combined tax liability on the $300,000 of taxable income is $86,264 (considerably more than that payable in the trust). Their combined tax liability could potentially be anywhere up to $108,232.00 on income of $300,000 during the income year if Mr A's income was instead $300,000 and Mrs B was not working.



Example – Trust Income Splitting versus Employees versus Company Dividend Distribution

Now, assume the structure is a company, A&B Pty Ltd, with taxable income of $300,000 during the income year. Its shareholders are Mr A, Mrs B and their three children C1, C2 and C3, each holding one share in the company. Mrs B is not working and C1, C2 and C3 are all university students aged over 18 and also not in receipt of any income. Mr A holds a number of investments outside of the trust which generate income of over $180,000 during the income year. The total tax liability of this structure is $71,188 (considerably more than that payable in the trust). This is due to the fact that Mr A must be distributed a dividend on his share which is equal to those of his other family members. With a trust, there is an ability to stream income versus shares where dividends are generally paid on a *pari passu* (non-preferential) basis to shareholders. The directors of the company cannot decide to exclude Mr A from the payment of the dividend. In this manner, trusts offer much more flexibility with respect to income distribution and can take into account income earned outside of the trust to produce the best tax outcome.



The above examples highlight that, given the same amount of taxable income in all three structures, the overall tax liability is lower in the trust due to the ability to split the net income of the trust between the members of the family group in a flexible manner. The result is that the beneficiaries are taxed at an overall lower marginal tax rate.[75]

4.2.2 Recommendation

An argument can be made that this can result in an unfair tax treatment when employees are unable to split their income in this manner and reduce their overall income tax liability by distributing to their lower income earning family members. These arguments were raised in the Ralph Review, which recommended a single entity tax that would apply uniformly for the taxation of companies, trusts, and limited partnerships as well.[76] The measures were aimed at protecting the income tax base by eliminating many sources of tax avoidance.[77] The government at the time put forward a modified version for the introduction of a common taxing regime for all entities, but it was withdrawn due to its unpopularity.[78] Similarly, in the 2019 federal election, the Australian Labor Party proposed a 30% tax on family trusts at beneficiary level to prevent family groups splitting income in this manner so as to avoid paying tax at high marginal rates.

One solution is to tax a family unit rather than individuals or to income average between spouses. However, this is a disincentive for the lower income earner (usually the female) to work given that individual will be taxed at a higher marginal rate. This issue is not easily resolved in theory or in practice. Some countries have the couple as the income tax unit (e.g. the United States) whereas others have the family (e.g. France). The approach adopted is ultimately a political and social decision. In most income distribution studies, the unit of study is the family or the income unit that comprises groups such as sole parents, couples and single persons.

4.2.3 Income Streaming

Provided the trust deed of the trust allows it, a trustee of a trust is able to stream income with special characteristics – such as capital gains and franked dividends – to any one or more beneficiaries. These amounts retain their same tax character in the hands of the beneficiaries when they are assessed on that income. This allows the minimisation of the tax liability of the family group.[79] Companies and other entities cannot stream income with special characteristics to beneficiaries in this manner.

These key taxation concepts were the subject of the 2010 High Court case *Commissioner of Taxation v Bamford*.[80] This case highlighted the discrepancies between the treatment of trust income by trust law and income tax laws. In

[75] Note, the tax calculations are based on the 2018-19 income year and do not include the Medicare Levy.
[76] Australian Government, Review of Business Taxation, *A Tax System Redesigned* (July 1999) Sections 11-15.
[77] Ibid.
[78] R Fisher, 'Ralph Review: Reform by Name but Not Nature?' (2003) 7(2) *Tax Specialist* 67.
[79] These general rules are subject to anti-avoidance measures such as the personal services income and Pt IVA issues.
[80] (2010) 240 CLR 481 ('*Bamford*').

response to *Bamford*, the ATO took the view that the proportionate approach adopted by the High Court would not permit the streaming of certain classes of income.[81] This view led to the legislative amendment effected by the *Tax Laws Amendment (2011 Measures No 5) Act 2011* (Cth). Schedule 2 to the Act amends Subdivision 115-C and Subdivision 207-B of the ITAA 1997 to ensure that, where permitted by the trust, the capital gains and franked distributions (including any attached franking credits) of a trust can be effectively streamed for tax purposes to beneficiaries, and these amounts retain their same tax character in the hands of the beneficiaries when they are assessed on that income.[82]

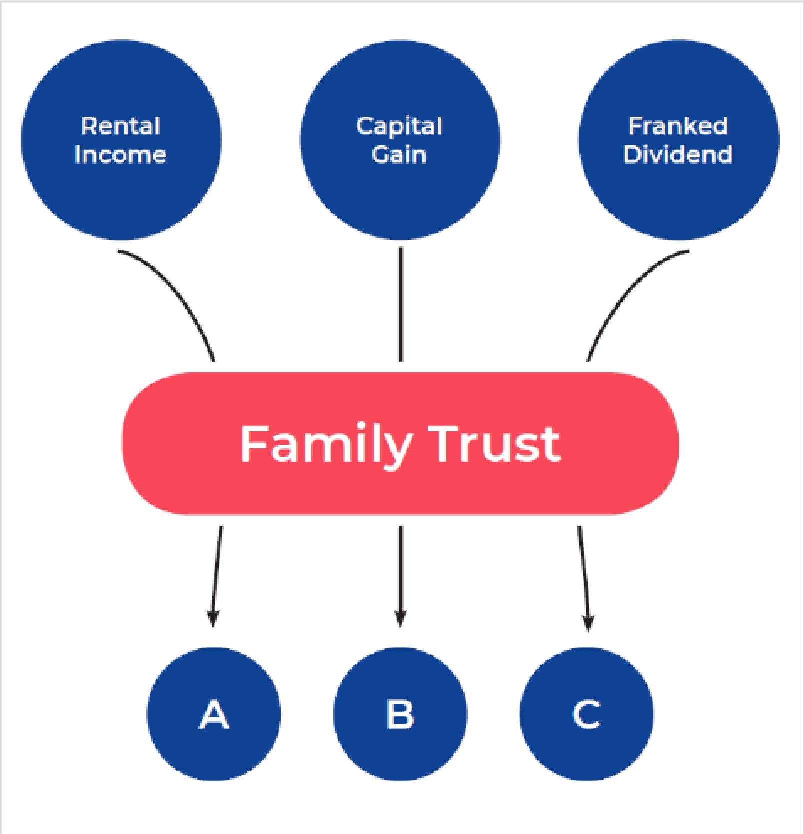


Diagram 5: Example of income streaming in a family trust

Prior to the introduction of the legislation, the ATO's view was that you could not divide the net income of the trust in this way and each of A, B, and C would take a proportion of each of the rental income, capital gain and franked dividend.[83]

[81] Refer to Decision Impact Statement on *Commissioner of Taxation v Phillip Bamford; Phillip Bamford v Commissioner of Taxation*, available at https://www.ato.gov.au/law/view/document?DocID=LIT/ICD/S310/2009/00001.
[82] Note that the ATO considers that the streaming of other types of income will not be effective.
[83] See *Bamford and Greenhatch v Federal Commissioner of Taxation* [2012] FCAFC 84.

Streaming may impact upon the distributions made by the trustee to reduce the structure's overall tax liability as follows:

- A trustee will not distribute a capital gain to a corporate beneficiary, as the 50% CGT discount discussed at 4.2.5 below will not be available.
- A trustee will not distribute franked dividends to a beneficiary that is a trust if it has not made a Family Trust Election and passed the relevant holding period rules (refer to 5.8).

4.2.4 Recommendation

Prior to the introduction of the *Tax Laws Amendment (2011 Measures No 5) Act 2011* (Cth), there was considerable uncertainty as to whether a trustee of a trust was able to stream income with special characteristics such as capital gains and franked dividends. The position is now clear. The ability to stream income does place trusts in an advantaged position relative to other business structures.

It is recommended that a 'single entity tax' be investigated which would apply uniformly for the income tax treatment of all companies, trusts, and partnerships and sole proprietors.

4.2.5 Access to 50% CGT Discount

The 50% CGT discount is contained in Division 115 of the ITAA 1997. Where the 50% CGT discount applies, the assessable portion of a capital gain is halved. The 50% CGT discount is available to trusts but not to companies. Advisers at the roundtable discussions noted that the 50% CGT discount was a 'big factor' in deciding whether to use a trust structure. The consensus was that there is more confidence around the 50% CGT discount compared to the other CGT small business concessions discussed at 4.2.7 below, as it has been around for a long time. Other concessions may not be around for the long term.

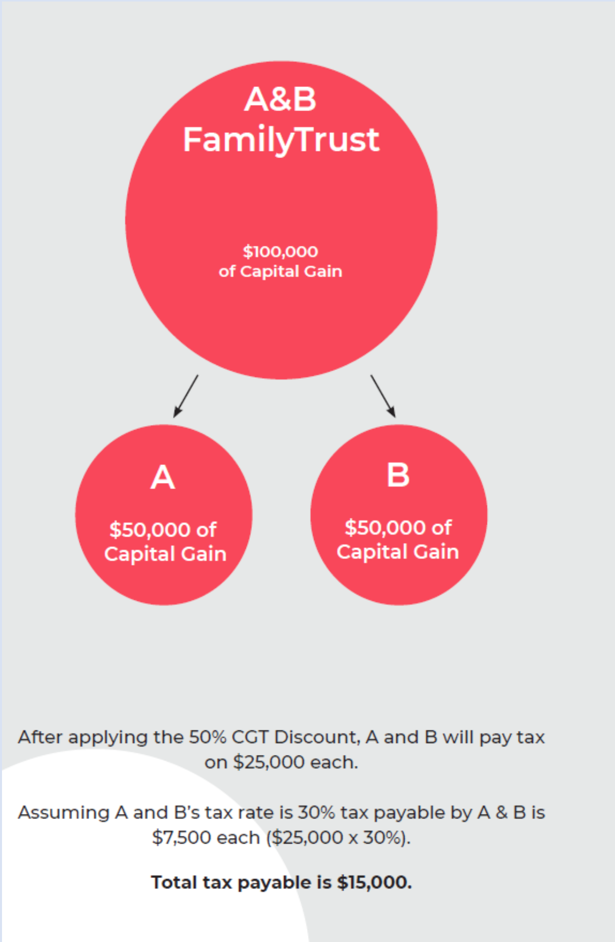
This can be an important consideration for clients as the sale of their business at a later date is likely to result in a capital gain. Further, there are different tax consequences depending on whether the disposal is of the business itself or an interest in the structure that conducts a business (i.e. shares). The choice of structure may result in considerable tax consequences at the point of disposal which could have been avoided. Careful consideration is given to what may happen with respect to the disposal of the business at the time a business structure is chosen or when an asset that is likely to appreciate in value (for example, land) is acquired. In particular, whether the chosen structure will allow the business owners to access the 50% CGT discount and the CGT small business concessions.

Advisers pay particular attention to the 50% CGT discount when they are considering whether to structure a business through a trust as opposed to a company structure. They are particularly concerned with the CGT liability at the point that the business disposes of assets or the business is sold, even though that may be many years down the track. Businesses that generate considerable goodwill or that are holding appreciating assets such as land are therefore likely to be operated through a trust structure. Alternatively, if these businesses are carried on through a company, a separate trust structure is likely to be set up to hold these assets, which are then licenced to the company structure operating the business for a fee. One of the key drivers for the business to be structured in this way is so that the CGT 50% discount can be accessed when the business, business assets or shares in the business are disposed of, generating a large capital gain. The choice of structure could result in considerable tax savings at the point of disposal.

Example – Sale of an Asset in a Trust versus a Company

Distribution from a Trust

An Australian resident family trust makes a capital gain of $100,000 on the sale of a CGT asset. To simplify, assume that no exemption or roll-over applies. Trust streaming allows the individual beneficiary of the trust to receive the capital gain. The capital gain retains its character when it is passed from the trust to the beneficiary or beneficiaries. The trust's net capital gain is taxed as if the beneficiary made the capital gain.[1] Provided there are no current year or prior year losses, the capital gain will be reduced by 50% as a result of applying the CGT Discount.[1] The taxable capital gain will be $50,000.

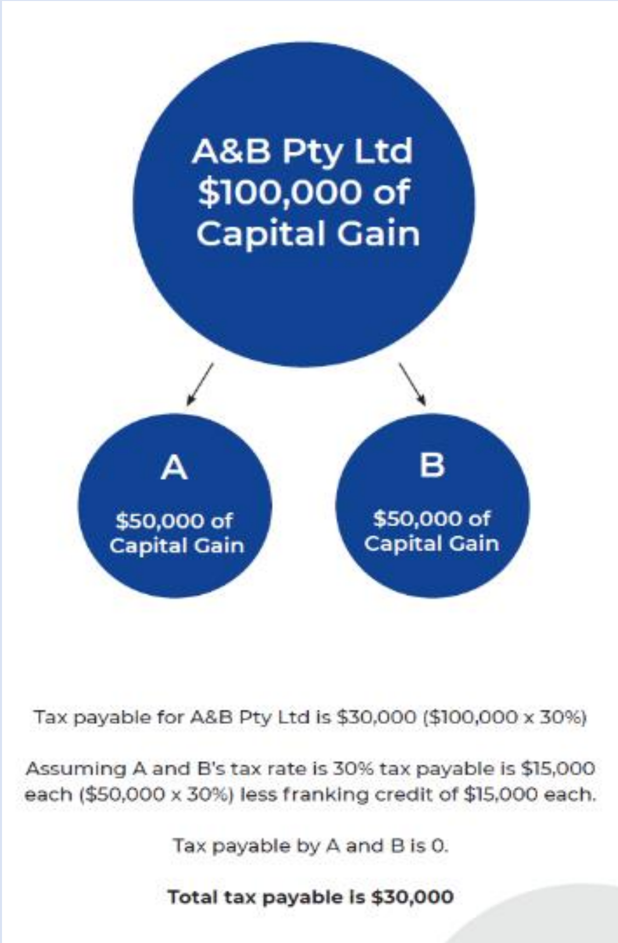


In this example, the trustee will avoid distributing the capital gain to a corporate beneficiary (i.e. bucket company) as companies are not eligible for the 50% CGT discount. This is because the capital gain will retain its character when it is distributed to the company.

Example – Sale of an Asset in a Trust versus a Company

Distribution from a Company

When a company sells a CGT asset it does not qualify for the 50% CGT discount. Instead, the capital gain is taxed at the company tax rate and then distributed out to shareholders as dividends. The shareholder then grosses the dividend back up to 100 percent, is taxed on that amount at the shareholder's marginal tax rate and can then reduce the tax payable by the refundable tax offset for franking credits.



4.2.6 Recommendation

The 50% CGT discount in Division 115 of the ITAA 1997 is available to individuals and trusts but not to companies. This puts trusts at an advantage over companies at the time of the disposal of assets in an entity. This is resulting in complex business structuring involving the combination of both companies and trusts in order for the respective businesses to be able to access the 50% CGT discount. It is recommended that a 'single entity tax' be investigated which would apply uniformly for the income tax (including CGT treatment) of all companies, trusts, partnerships and sole proprietorships.

4.2.7 Accessing Small Business CGT Tax Concessions

For many business owners, much of their personal wealth is tied up in their business. When a business is sold, capital gains tax can significantly impact upon how much wealth the owners are able to retain and, if retiring, this amount will be used to fund their retirement. The CGT discount and small business CGT concessions can dramatically reduce and even eliminate the amount of tax payable on the sale of the business. These rules are very complex in their operation.

An entity must qualify as a 'small business entity' in the income year in which the transfer takes place, as well as satisfy a number of other requirements discussed below. A 'small business entity' is a business entity with an annual turnover which, when combined with that of its affiliated and connected entities, is less than $2 million, or with a maximum net asset value which, when combined with that of its affiliated and connected entities, is less than $6 million.[84]

A business structured through a family trust could potentially be eligible to access all of the CGT small business concessions on the disposal of its business assets provided the requirements under the relevant concession in Subdivision 152 of the ITAA 1997 are met. The flow through nature of a trust allows these concessions to be accessed. There are four CGT small business concessions:

- 15-year retirement exemption;[85]
- 50% active asset reduction;[86]
- Active Asset Retirement Exemption;[87] and
- Small Business Active Asset Rollover.[88]

Each of these are concessions will be discussed in greater detail shortly.

The advisers at the roundtables were of the view that the small business concessions are complex and require them to look at their client's situation in great detail; in particular, to work out whether the '20% stakeholder test' (see further below) can be satisfied. The advisers commented that often they feel that they require a 'crystal ball' to advise as the rules are so prescriptive and change frequently over time. They expressed that they can only really advise on the law at the present whilst flagging potential future changes.

15-year retirement exemption[89]

If the eligibility criteria for this exemption can be met, a full exemption from CGT will be allowed. To be eligible for the exemption:

[84] This test does not include the net value of superannuation funds, a main residence or private use assets owned by an individual.
[85] Subdivision 152-B of the ITAA 1997.
[86] Subdivision 152-C of the ITAA 1997.
[87] Subdivision 152-D of the ITAA 1997.
[88] Subdivision 152-E of the ITAA 1997.
[89] Subdivision 152-B of the ITAA 1997.

1. the business entity must have continuously owned the 'active asset' for the 15-year period ending just prior to the disposal of the asset. Active assets include goodwill, licences and other CGT assets used in carrying on a business;[90]
2. the company or trust must have had a 'significant individual' at all times during that 15-year period including in the year of disposal. This need not be the same individual at all times. In general terms, a significant individual is an individual who receives distributions of at least 20% of the income and capital of the trust in that year; and
3. a significant individual of the company or trust must be 55 years of age or greater at the time of the CGT event and the event must happen in connection with the significant individual's retirement, or they must be permanently incapacitated at the time of the CGT event.

Example

Mr A and Mrs B have three children. All five persons are beneficiaries of the A&B family discretionary trust. Mr A, Mrs B and their three children are significant individuals of the A&B family trust. The trust makes a capital gain of $100,000 on the sale of a CGT asset of the business. The trust owned the asset and was using it in the business for more than 15 years and Mr A is 58 years old and plans to retire from the family business. The gain qualifies for the 15-year exemption because it meets the eligibility criteria above. In the next income year, the trustee distributes that amount equally to Mr A and Mrs B, and their three children. Mr A and Mrs B and their three children are each able to treat the distribution of $20,000 as an exempt amount.

50% active asset reduction[91]

This exemption applies in addition to the 50% CGT discount described above to reduce the capital gain by an additional 50% (i.e. reduction of 75% of the capital gain once both concessions are applied). To be eligible for the exemption[92] the disposal assets must be 'active assets'.

Example

The A Family Trust makes a capital gain of $100,000 from the sale of a licence (i.e. active asset). The A Family Trust has no capital losses and satisfies the eligibility criteria for the 50% CGT discount, as well as the small business active asset reduction. The trust's net capital gain is $25,000 ($100,000 x 50% x 50%). The A Family Trust then distributes the net capital gain out to Mrs A. Mrs A works out her capital gain as follows:

[90] Generally, financial instruments and assets mainly used to derive interest, rent and other passive income streams will not qualify as active assets.
[91] Subdivision 152-C of the ITAA 1997.
[92] The taxpayer must satisfy certain conditions outlined in subdivisions 152-A and 152-C of the ITAA 1997.

Share of trust net capital gain	$25,000
Gross up this amount by multiplying By 4 ($25,000 x 4)	$100,000
Apply 50% CGT discount ($90,000 x 50%)	$50,000
Apply 50% reduction ($45,000 x 50%)	$25,000
Net capital gain	$25,000

Active Asset Retirement Exemption[93]

The exemption applies in addition to the 50% discount and 50% active asset reduction. The exemption requires a capital gain to be rolled over into a complying superannuation fund if the relevant individual is under 55 years of age. There is a lifetime limit for the amount of a capital gain that can be eligible for the exemption of $500,000 per person. To be eligible for the exemption if the entity that makes the capital gain is a company or trust, it must have a 'significant individual' in the year in which the disposal occurs.

Example

Referring to the example above, after applying the CGT discount and small business active asset reduction, Mrs A has a capital gain of $25,000. Mrs. A could choose to further reduce her net capital gain by applying the active asset retirement exemption. However, if she is younger than 55 years old, she would need to pay the amount to a complying super fund or Registrable Superannuation Entity (RSA). If the funds are needed for reinvestment back into the business, she may choose not to use the active asset retirement exemption.

Small Business Active Asset Rollover[94]

This rollover applies in addition to the 50% CGT discount, the 50% active asset reduction, and the active asset retirement exemption described above. To be entitled to the small business active asset rollover (effectively deferring the remaining taxable gain), the taxpayer must acquire replacement active assets within the period commencing one year before, and ending two years after, the disposal of the existing active assets. Where a capital gain is rolled into replacement active assets, the capital gain is deferred until a disposal of those assets or the assets ceasing to be active assets.

Example

In October 2018, the A Family Trust makes a capital gain of $1,000,000 on an active asset and chooses to disregard the entire capital gain under the small business active asset rollover. In November 2019, the A Family Trust purchases

[93] Subdivision 152-D of the 1997 Act.
[94] Subdivision 152-E of the 1997 Act

new business premises for $800,000 and spends another $200,000 on improving some other assets. The replacement and capital improved assets meet all the eligibility criteria above. The capital gains tax liability is therefore deferred until the subsequent sale of these assets.

4.2.8 Recommendation

Whilst the policy behind the small business CGT concessions in Subdivision 152 of the ITAA 1997 is sound, the complexity of the provisions is overwhelming, even for the most experienced adviser. Small business owners are unable to work through even the most basic conditions of these concessions, particularly when there are trusts and companies involved in the business structure. It is recommended that the small business CGT concessions in Subdivision 152 of the ITAA 1997 be simplified.

4.2.9 Other Tax Concessions Available to Small Business Entities

In addition to the small business CGT concessions discussed above, there are a number of other small business tax concessions available to small businesses, including those carried on through a trust, company, partnership or as a sole proprietorship. A small business that satisfies the $10 million small business entity test[95] can choose to access the following 10 concessions (subject to any additional criteria in the particular concessions):

Immediate deductibility for small business start-up expenses	Subsection 40-880(2A) of the ITAA 1997
Simpler depreciation rules	Subdivision 328-D of the ITAA 1997
Simplified trading stock rules	Subdivision 328-E of the ITAA 1997
Restructures of small businesses	Subdivision 328-G of the ITAA 1997
Deducting certain prepaid business expenses immediately	Sections 82KZM and 82KZMD of the ITAA 1936
Accounting for GST on a cash basis	Section 29-40 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth)
Annual apportionment of input tax credits for acquisitions and importations that are partly creditable	Section 131-5 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth)

[95] From 1 July 2016, you are a small business entity if you are a sole trader, partnership, company or trust that operates a business for all or part of the income year, *and* has an aggregated turnover less than $10 million (the turnover threshold).

Paying GST by quarterly instalments	Section 162-5 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth)
FBT car parking exemption	Section 58GA of the *Fringe Benefits Tax Assessment Act 1986* (Cth)
PAYG instalments based on GDP-adjusted notional tax	Section 45-130 in Schedule 1 to the *Taxation Administration Act 1953* (Cth)

A $5 million small business entity test applies in order to access the small business income tax offset in Subdivision 328-F of the ITAA 1997. Additionally, for the 2018–19 and 2019-20 income years, the tax rate for a company carrying on a business with aggregated annual turnover less than $50 million is 27.5 percent. From 2020–21, the tax rate for these entities will be further progressively reduced to 26 percent and then down to 25 percent for the 2021–22 and later income years. The company tax rate is 30 percent for all other companies.[96]

4.3. Asset Protection

One of the key reasons why business families will choose to use a trust as part of their business structure is that trusts provide a level of asset protection not readily available through other types of legal entities. As business families are concerned with growing their wealth, they are understandably interested in taking steps to limit the risk associated with claims being made against the family business and/or a family member.

As assets of a family trust are not legally owned by any individual family member (even though the family member may be listed as a beneficiary of the trust),generally speaking, creditors of the family business will not be able to access trust assets.[97] Similarly, in the event of a marriage breakdown, trust assets generally cannot be accessed as part of a divorce settlement, even though one of the individuals is listed as a beneficiary of the trust.

As explained at 1.2.3, when operating through a family trust, the trustee:

- is responsible for the liabilities of the business and the claims made by creditors, employees and clients against the trust;
- is entitled to be indemnified from the assets of the trust;
- is personally liable if the assets held in the trust are insufficient to meet the claims of creditors, employees and clients; and
- has no right of indemnity against the beneficiaries of a discretionary trust except in a very limited range of circumstances.

[96] *Treasury Laws Amendment (Enterprise Tax Plan) Act 2017* (Cth); *Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2018* (Cth); *Treasury Laws Amendment (Lower Taxes for Small and Medium Businesses) Act 2018* (Cth).
[97] Note that in recent years, asset protection provided by trusts has been brought into question. See *Richstar Enterprises Pty Ltd v Carey (No 6)* [2006] FCA 814 (‘*Richstar*’)

This is why the trustee of a family discretionary trust is often a corporate beneficiary, benefitting from the asset protection advantages of limited liability. Many of the common structures above allow for asset protection by minimising the assets of the operating entity that has the commercial exposure and instead holding the assets in a separate 'asset holding' entity, which is passive in nature and therefore not exposed to the same level of commercial risk. Personal assets and externally-owned assets of the beneficiaries of a family trust would ordinarily be protected from the liabilities of the business and the claims made by creditors, employees and clients.

4.4. Reduced Regulatory Burden

As highlighted earlier at 3.2, the most common legal structure used by Australian businesses operating in the private sector (i.e. non-government entities) is a company structure. Companies are subject to a number of obligations under the *Corporations Act 2001* (Cth). The regulatory burden of a privately-owned company is dependent on its size. One of the advantages of operating a business through a trust compared to a company structure is the reduced regulatory burden. Businesses operated through a trust are not subject to the same reporting obligations that many companies are subject to. This is particularly appealing to family businesses because of their preference for privacy and their ability to limit information publicly available to competitors. For example, large proprietary companies are required by the *Corporations Act 2001* (Cth) to submit audited financial reports that are prepared using Australian Accounting Standards to the Australian Securities and Investment Commission. This represents a significant cost to such companies.

4.5. Economic and Non-economic Factors

There is a growing body of research which suggests the behaviour and performance of family businesses is distinctly different to that of other businesses. Family owners are driven by economic as well as socioemotional wealth (SEW) objectives and it is this dual pursuit of both types of objectives that set them apart from other ownership groups. For example, family businesses are willing to be exposed to higher levels of performance risk in order to achieve their SEW objectives.[98] Simply put, SEW is described as the affective value that the owning family places on the achievement of particular non-economic objectives. The acronym FIBER is often used to describe the five common SEW objectives of family businesses; namely, family control (F), identity through the business (I), binding ties with different stakeholder groups (B), emotional cohesiveness and loyalty among the family (E), and renewal through succession to the next generation (R).

The prevailing view from the roundtable discussions was that, because of their flexibility, family trusts are well-suited for catering to the economic and SEW objectives of family firms. For example, trusts are exclusively about the rights that accrue to family members and are therefore appropriate for family businesses that place a high importance upon

---

[98] See for example L R Gómez-Mejía, K T Haynes, M Núñez-Nickel, K J L Jacobson, and J Moyano-Fuentes, 'Socioemotional Wealth and Business Risks in Family-Controlled Firms: Evidence from Spanish Olive Oil Mills' (2007) 52(1) *Administrative Science Quarterly* 106.

continuity of family control (F) over the business and related assets. Moreover, as highlighted in 4.6, one of the advantages of family trusts is their ability to cater for the changing needs of family members. As a consequence, family trusts are well-suited to assisting in business families in preserving family cohesiveness and loyalty (E).

One adviser also noted that the motivations of clients is significant. Family trusts may be used with the desire to set up the next generation, whereas a company may be used by arm's length parties carrying on a business. As highlighted later in this report, when appropriately set up and used, family trusts have significant advantages in assisting business families in passing on control of the family business to the next generation and consequently facilitating renewal (R).

Example

A and B operate the family business through a family trust, with the trustee set up as a trustee company, and A and B as the shareholders (with one share each) and directors of the trustee company. A, B and their two adult children are listed as beneficiaries of the trust. A and B have control of the family business through (a) being the shareholders and directors of the trustee company and (b) being listed as the appointors in the trust deed.

The family is driven by the SEW objectives of perpetuating family control (F) of the business and are consequently concerned with developing the next generation so that they are ready to assume control of the business (R) when the time is right. As part of preparing their two adult children for taking over the business, they enjoy the flexibility of the family trust by being able to distribute trust income to support their adult children through their university studies. After finishing their studies, the two children commenced working in the business (see Diagram 6, 'entering the business'). They also eventually appoint the two children as directors of the trustee company to run the family business together. This provides them with the opportunity to share the responsibility of providing oversight of the family business (see Diagram 6, 'working together').

When the time came to pass the responsibility of managing the family business solely to the children, A and B stepped down as directors of the trustee company and passed their shares in the trustee company to the children. The parents remained as appointors and consequently have overall control of the family business as a safeguard to ensure that the overall wealth objectives of the family as a whole are preserved. When the parents passed away, the two children were made appointors of the trust. In effect, control of the family business has passed to the children in a measured way without incurring any CGT liabilities, thereby preserving the wealth tied up in the family business.

The above example illustrates how a trust structure can be an effective way to plan and execute the transfer of control of the family business to the next generation in a staged manner. Such an approach enables the family to develop the next generation and hand over responsibility as they develop and prove themselves capable. If there are concerns about the children carrying out their duties responsibly (e.g. concerns for potential sibling rivalry), a parent (or parents) can remain appointors so that they can intervene for the sake of the family's wealth and wellbeing.

A number of advisers at the roundtable sessions emphasised that the efficacy of using trusts to pursue economic and SEW objectives of the family is very much dependent on the functionality of the family unit itself. When there is family conflict, the flexibility of trusts may be used to favour some family members to the detriment of others. This is why, as with any structure, it is critical that business families implement the appropriate governance structures to ensure effective oversight and alignment of the family and the business towards achieving the family's overarching wealth objectives.

4.6. Flexibility during the Business and Family Lifecycle

One of the characteristics that make family businesses different from other businesses is that they are comprised of three overlapping systems: the business system, the ownership system and the family system. These overlapping systems are not static but progress through their own lifecycles with their own challenges and needs. Taken together, it is common for business families to be dealing with multiple interrelated transitions at a point in time (e.g. handling succession to the next generation while at the same time renewing the business model for growth). As a result, it is important that family businesses adopt a legal structure that empowers them to respond to needs brought about by business, ownership and family lifecycle transitions.

Compared to other structures, operating the business through a family trust provides the flexibility for business families to address the issues surrounding ownership, business and family transitions. For example:

- Ownership transitions – in the context of family trusts, it is the trust that owns the business and/or business assets. As a consequence, ownership transition is more about transition of control of the business, rather than ownership per se. As discussed later in this report, family trusts can have advantages in assisting business families in transitioning control from one generation of the family to the next generation due to the flexible nature of family trusts. At the same time, emphasis on control restricts options for equity financing, as outlined later in 5.3.

- Business transitions - the trustee of a family trust has the flexibility to consider the different (and sometimes competing) needs of the business and the family. For example, if the business is undergoing a growth or renewal phase, the trustee can choose to limit distributions to beneficiaries in order to retain funds for much needed business finance. Note that under current tax rules, businesses operated through family trusts may choose not to use this option because of the taxation of profits retained in the trust at the highest marginal rate). This is discussed further in 5.5.

- Family transitions – similar to that of a company structure, family trusts provide the flexibility to parents to appoint their children as leaders of the business while at the same time maintain overall control until such time that the transfer of control is appropriate. Compared to company structures, trusts have greater flexibility in catering for family transitions and needs. Unlike a company where profit distributions are determined by shareholdings, with family trusts the trustee has discretion to make distributions to family members according to their needs and the family's interests overall. For example, in preparing the next generation for future leadership of the business, the trust may distribute additional income to fund the next generation's preparation for leadership e.g. further education. Distributions can be made to address a range of different needs of a family when they arise. This may include providing for family members with disabilities, health needs, and additional support to young families such as when one adult may take on the primary care needs of the children.

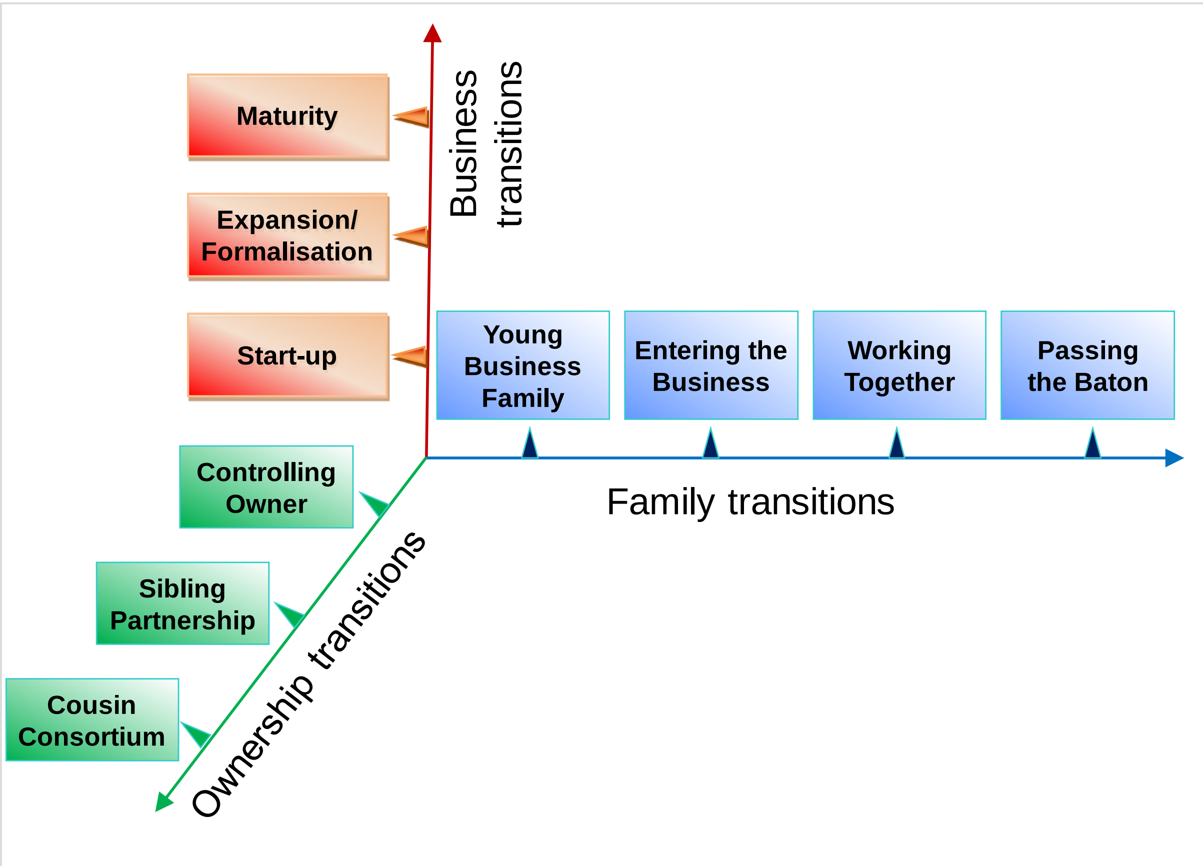


Diagram 6: Lifecycle of a Family Business[99]

Advisers at the roundtables agreed that trusts are generally more flexible, whereas for example, the *Corporations Act 2001* (Cth) applies to companies. With a trust, there is an ability to stream income versus shares where dividends are generally paid on a *pari passu* (non-preferential) basis to shareholders. This was highlighted by an example provided by one of the advisers: a client wanted to make equal trust distributions to his daughters despite the fact that it would result in paying more tax in total. It was highlighted that the client was able to make the choice (to distribute the

[99] K E Gersick, J A Davis, M M Hampton and I Lansberg, *Generation to Generation: Life Cycles of the Family Business* (Harvard Business School Press, 1997).

income of the trust equally, or on the most tax-effective basis), whereas if the daughters held shares in a company, there would be no choice.

In the family business context, the trustee's discretionary powers may generate conflict. Rival siblings working in the business may contend that they have exerted greater efforts and therefore deserve higher distributions. Alternatively, parents may withhold making any kind of meaningful distribution or delay the transfer of control over the business to their children, to the children's chagrin.[100] This was a commonly cited issue the advisers at the first roundtable session, who routinely assist in administering family trusts operating as a business.

[100] A common reason for this is parental mistrust; the fear is that 'spendthrift' child beneficiaries will promptly waste the funds or other trust property they receive: Dale Bocabella, 'Beware the Pitfalls of the Discretionary Family Trust', *The Conversation* (9 January 2013) <https://theconversation.com/beware-the-pitfalls-of-the-discretionary-family-trust-11224>.

5. Issues Arising When Using a Family Trust Structure to Carry on a Business

5.1 Introduction

There are a number of issues that arise when using a family trust structure to carry on a business. Many of these issues were raised and then discussed in detail at the roundtable sessions. There was also discussion as to how some of these issues can be addressed. In particular, the main issues arising concerned the complexity of trust law, the difficulty in being able to raise capital in a trust structure, a number of tax and business succession issues, as well as a general sense of a problem with the lack of public education with respect to trusts.

5.2 Complexity

5.2.1 Division 6 of the *Income Tax Assessment Act 1936* (Cth)

The Federal Government's 'Australia's Future Tax System Review', chaired by Australian economist and former Secretary of the Department of the Treasury, Dr Ken Henry, was released on 2 May 2010.[101] The review recommended that trust rules remain as they are in principle, though Recommendation 36 of the report stated: 'The current trust rules should be updated and rewritten to reduce complexity and uncertainty around their application'. On 21 November 2011, Treasury issued a consultation paper titled 'Modernising the Taxation of Trust Income – Options for Reform', which discussed three potential reform options ranging from minor changes to the current operation of Division 6 to the introduction of a new model for the taxation of trust income, however these initiatives were never carried out.[102]

As discussed earlier in this report, reflecting on the development of Division 6 of the ITAA 1936 and trading trusts in Australia, academic commentators have noted that trusts that are carrying on a business do not fit easily within this statutory framework.[103] The Henry Review also noted the difficulties of applying Division 6 of the ITAA 1936 to trading trusts. One example of this difficulty is the complex process involved in being able to calculate the 'distributable income' of the trust at the end of each income year. There are many layers in being able to calculate distributable income. Advisers at the roundtable sessions noted that in order to be able to calculate the distributable income of the trust they must work through:

---

[101] Ken Henry et al, *Australia's Future Tax System*, Report to the Treasurer (December 2009) ('the Henry Review').
[102] Treasury, 'Modernising the Taxation of Trust Income — Options for Reform' (Consultation Paper, Treasury, November 2011.
[103] The assumption on which Div. 6 and its antecedents were drafted was that there would be no significant differences between net or distributable trust income and what would be calculated as the notional taxable income of the trustee...Once a business is embarked upon, however, a whole range of discrepancies emerge. Differing views on key concepts, such as 'present entitlement', 'income of the trust estate' and 'share', create uncertain tax outcomes for taxpayers, increasing compliance and administration costs.

- The case law, including the *Bamford* decision, which sets out much of the law with respect to the operation of Division 6 of the ITAA 1936;
- The interim modifications to Div. 6E interpretation *Tax Laws Amendment (2011 Measures No. 5) Act 2011* (Cth) which came into effect from 1 July 2010. These provisions deal with specifically entitled beneficiaries, streaming of capital gains and franked credits and were only intended to be an interim measure until such time that Division 6 was rewritten; this is yet to eventuate almost 10 years since the enactment of those provisions;
- The ATO's interpretation of Division 6 of the ITAA 1936 as well as draft tax rulings such as Taxation Ruling 2012/D1, which were supposed to be finalised when the new legislation came out, however they are still sitting in draft form;
- The trust deed of the trust, including any modifications to the deed.

Another example given was that of the various methodologies that the trustee employs to calculate 'income of the trust estate' under Section 97 of the ITAA 1936, which can have various meanings. For example, depending on the trust deed of the trust, 'income of the trust estate' can be interpreted as being ordinary income, accounting income, trust income or tax income.

5.2.2 Recommendation

The current operation of the rules in Division 6 of the ITAA 1936 is unclear, uncertain and in many cases unworkable. There is a clear case for the need to review and rewrite Division 6 so that the manner in which the Division operates is clear and does not impose additional compliance burden on small business and family enterprise. Given that any changes will have greatest impact upon small business and family enterprise, to avoid any unintended consequences, it is recommended that the small business and family enterprise sector is consulted prior to any draft bills being released.

5.3 Raising Capital

Research suggests that family businesses follow a pecking order when it comes to acquiring capital for the business.[104] Specifically, family businesses tend to approach sources of finance in the order highlighted below, with grants and subsidies being the most desired source of capital and equity from outsiders being the least desired source. Compared to a company structure, operating a business through a family trust presents challenges for raising capital from the five key sources highlighted below.

[104] J Lappalainen and M Niskanen, 'Behaviour and Attitudes of Small Family Firms Towards Different Funding Sources' (2013) 26(6) *Journal of Small Business & Entrepreneurship* 579.

1. Grants and subsidies

Despite being the most attractive source of capital for family businesses, those family businesses operated through a trust are not able to access grants available to incorporated entities. For example, family trusts are not able to access R&D tax offset concessions or the Australian Government's Accelerating Commercialisation program.[105]

2. Internally generated equity (retained income, capital contributions from family members)

Aside from grants and subsidies, internally generated equity is one of the most popular sources of capital for family businesses. One of the challenges that family trusts face is the difficulty of retaining income within the trust as a source of capital to grow the business. As discussed later in this report, trust income that is not allocated to any beneficiary is taxed in the hands of the trustee at the top personal income tax rate, along with the applicable Medicare levy. As a consequence, the trustee will generally allocate the income of the trust to beneficiaries to avoid paying tax at the highest rate. If income needs to be retained in the trust to finance business activities, a bucket company is typically set up to receive trust distributions.

The trust does not actually pay the distribution, rather, an 'unpaid present entitlement' or 'UPE' is created (in effect, a loan).[106] As discussed later in this report, there are concerns surrounding the application of Division 7A of the ITAA 1936 to UPEs, which will significantly limit the ability of trusts to use income for financing the business. Given the fact that small to medium enterprises (SMEs) face barriers to acquiring the necessary finance for investment for growth,[107] the inability to keep retained profits within a trust for financing business investment has a detrimental effect on business growth and employment.

3. Short-term debt (overdraft, trade creditors, credit cards)

Use of short-term debt is a popular source of finance because it enables business families to generate finance without compromising their SEW objectives. However, short-term debt is not suitable for financing long-term investments because of the higher interest rates. As a consequence, the challenge for many family businesses is acquiring the necessary long-term finance, as outlined in sources (4) and (5) below.

---

[105] In certain circumstances, businesses operated through a trust may be eligible for certain grants and concessions if they agree to establish a corporate trustee or agree to establish a for-profit company.
[106] On UPEs, see 5.5.1.
[107] Australian Small Business and Family Enterprise Ombudsman, *Barriers to Investment: A study into Factors Impacting Small to Medium Enterprise Investment* (2017) Office of the Australian Small Business and Family Enterprise Ombudsman, Canberra.

4. Long-term debt

The consensus at both roundtable sessions was that raising debt is more difficult when a business is structured through a trust rather than through other common business structures. Concerns were expressed around using a family trust when seeking debt finance, and the general view was that companies tend to be given preferential treatment by the banks. One adviser spoke of a recent matter and noted that, on three separate occasions, banks had requested that every potential beneficiary of the respective family trust be identified and sign off on documents.

It was the consensus that employees of banks are not entirely aware of how a trust works. A related issue that was identified is that there is no ‘standard’ trust deed, which means that banks will always want to see the specific deed underpinning the relevant trust. The difference in complexity from one trust instrument to the next complicates matters. The advisers noted further that the banks will want more information and to look over trust deeds. However, the advisers were of the view that the main concern for banks was in demonstrating that the underlying security is sufficient.

5. Equity from outsiders (non-family members, including from sources such as High Net Worth Individuals and Private Equity firms)

The consensus view at the roundtable discussions was that it is extremely difficult to introduce new independent investors into a business carried on through a family trust. The advisers noted that if their family business clients are looking to raise capital externally, those operating through a trust structure must be restructured into a company before the independent investors will provide capital to the business.

In the company model, the introduction of a new investor is easily facilitated. The transition can occur by one or more of the following: (a) the sale of shares by the original owners to the incoming investor; (b) the issue of new shares to the incoming investor; and (c) the buy-back and cancellation of shares of the original owners. Each transition would involve the potentially ‘simple’ steps of a share sale agreement and accession to the shareholders agreement. Each of the transactions will have its own separate tax consequences however, broadly speaking, the sale of shares by the original owners may be tax free if one or more of the CGT small business concessions discussed earlier apply. The issue of new shares to the incoming investor, or the buy-back and cancellation of shares of the original owners, should have no tax impact if it occurs at market value.[108]

[108] No value shifting arising or capital steaming arising. No stamp duty on incorporated shares. The transactions should be input taxed for GST, being dealings in shares.

Given that median age of CEOs of Australian family businesses is between 55 and 64 years and around 30 percent of these businesses intend to transfer some or all of the family's control to outsiders (i.e. non-family members),[109] the challenges associated with this form of financing in family trusts is likely to grow in coming years.

5.4 Small Business Restructuring

There are a number of reasons why the initial structure adopted by the owners or their advisers to carry on the business may no longer be appropriate. During the roundtable discussions, it was noted that advisers are most likely to advise their clients to restructure their business in the following situations:

- to simplify the business structure. Some advisers noted that a restructure may be required where there is a 'weird structure that has been accumulated over time' and that a restructure may be used to 'clean this up';
- to enable the addition of new investors into the business;
- to address Div. 7A issues arising from working capital retention;
- to prepare a business for sale;
- to access the R&D concessions;
- where the original owner has died;
- where the next generation desires to carry on businesses independently of each other;
- where one family member wishes to cease their involvement in the business.

A number of considerations are taken into account when restructuring, particularly taxation issues (income tax, CGT, stamp duty and GST). Other considerations may relate to the continued operation of the business post-restructure, such as who is going to exercise control and decision-making power. Restructuring is more complex in a mature business where there may be significant CGT incurred on the transfer of the assets or interests as part of the restructure. The tax law includes a number of roll-over provisions which are aimed at deferring, but not eliminating, the CGT liability without any CGT being payable at the time of the restructure.

The roundtable advisers referred to a number of CGT restructuring provisions that they would most commonly utilise in order to restructure the business. The most commonly cited was Subdivision 122-A of the ITAA 1997, however Subdivisions 124-N, 328-G and scrip for scrip roll-overs[110] were also commonly used. Subdivision 122-A of the ITAA 1997 allows a trustee of a trust to dispose of the assets of the trust to a company without incurring a CGT liability. There are some integrity measures in this subdivision which must be met for the roll-over to occur.

[109] C Graves, F Barbera and J Thomas, *KPMG-Family Business Australia 2017/2018 Australian Family Business Survey* (2018), The University of Adelaide, South Australia.
[110] A scrip for scrip roll-over is essentially a mechanism that allows you to defer paying CGT until a later CGT event occurs. For example, if a company in which you own shares is taken over and you subsequently acquire new shares in the takeover company, you may be eligible for a scrip for scrip roll-over. For more information see https://www.ato.gov.au/Forms/Guide-to-capital-gains-tax-2018/?page=39.

Other restructuring options cited were to commence a new business in the preferred structure and wind down the existing business, taking advantage of the 50% CGT discount and the small business CGT concessions in the restructure to eliminate any CGT liability. The benefit of restructuring in this manner is that the deferred CGT liability is extinguished, meaning that CGT will only be payable on the capital gain following the restructure. The consensus at the roundtable discussions was that the analysis of the tax consequences of a restructure occurs prior to any restructure being undertaken and that generally clients would not want to restructure their business if there was a tax cost.

Example – Subdivision 122-A of ITAA 1997

The A Family Trust carries on a business which has expanded considerably and it is decided by the owners that new investors need to be introduced into the business to facilitate further expansion. Assume, for simplicity, that the business only has the following two assets:

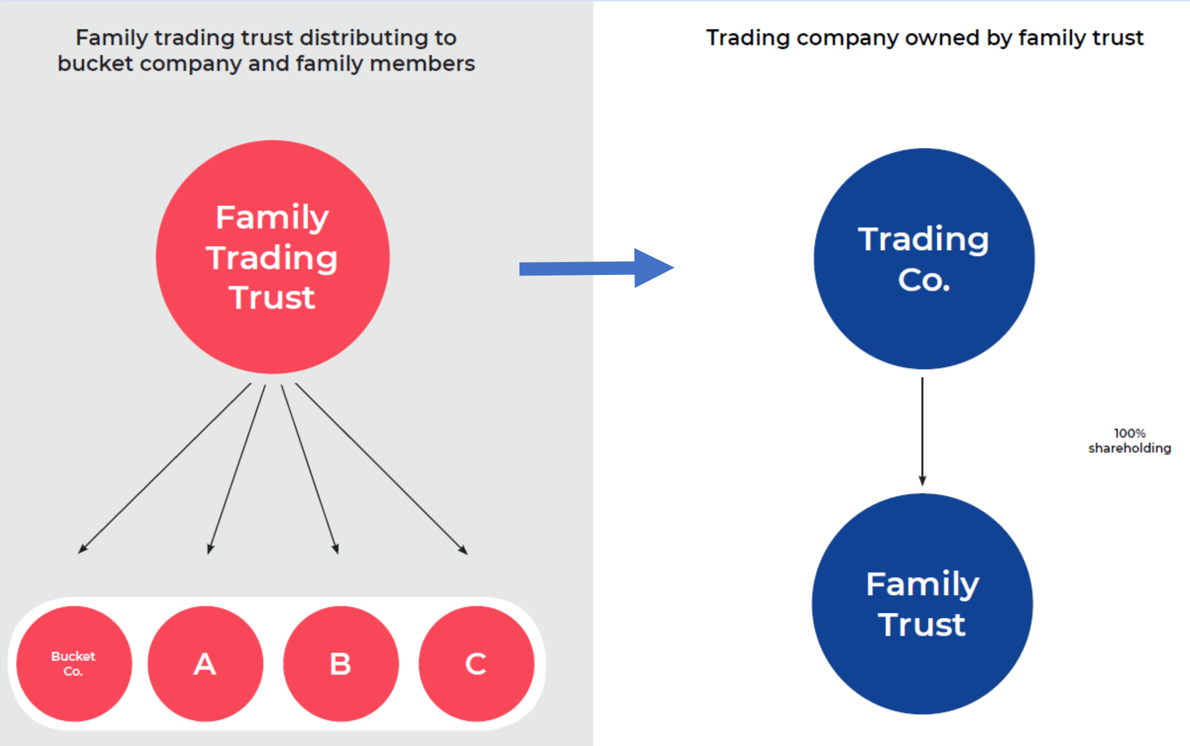
- goodwill, which has a market value of $1 million and a cost base of nil; and
- depreciating assets, which have a market value of $1.5 million and a cost base of $500,000.

A bucket company has been set up which has retained earnings of $500,000 represented as a UPE of the A Family trust of $500,000. This amount has been reinvested into the A Family trust and has helped to facilitate the growth of the business. The owners of the business decide to restructure the business for the following reasons:

- their current business structure is not appropriate given they wish to introduce third-party investor(s);
- Div. 7A issues resulting from the $500,000 of UPEs;
- the current business structure provides limited asset protection.

A Subdivision 122-A roll-over will result in a company becoming the new operating entity or asset holder, and the A Family Trust will become the shareholder of the company.[111]

[111] A depreciating asset will be excluded from the roll-over protection of subdivision 122-A (pursuant to subsection 122-25 (2)). However, Subdivision 40 provides similar relief to Subdivision 122-A. The end result is that, despite a depreciating asset being excluded from Subdivision 122A roll-over relief, there is a roll-over relief that applies under Subdivision 40 in respect of any balancing adjustments: Section 40-340.

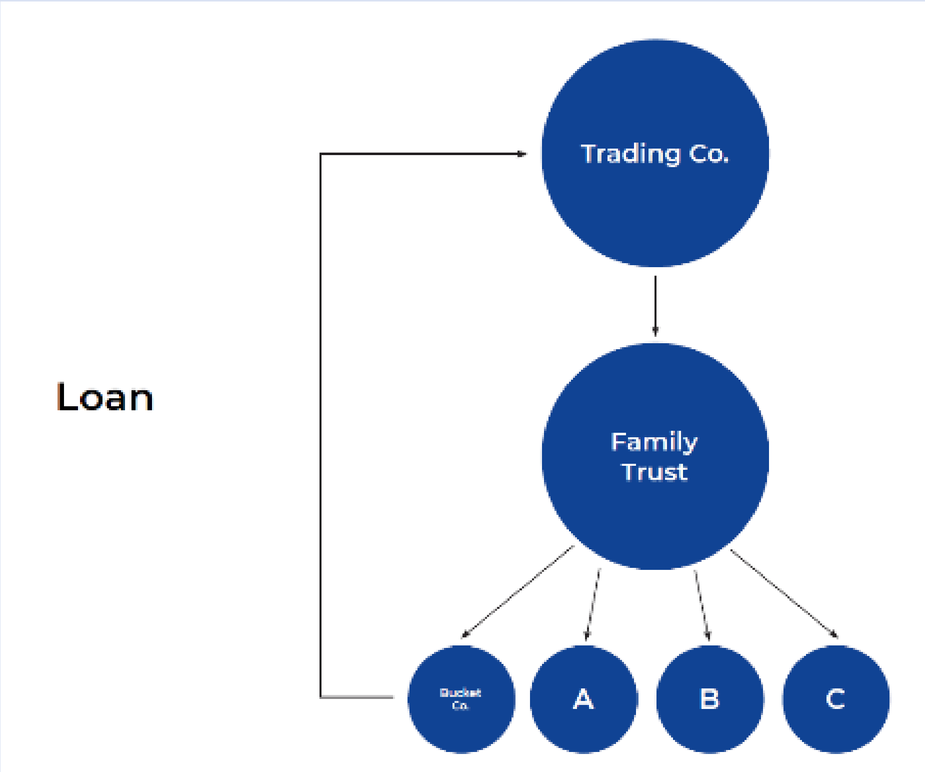


Before Subdivision 122-A roll-over After Subdivision 122-A roll-over

After the restructure, the businesses profits will be taxed in the company at the company tax rate. The company can then distribute this profit to the A Family Trust in the form of a dividend. Provided that the A Family Trust makes a Family Trust Election (so that the trust can satisfy the 'qualifying person' requirement), then franked dividends are able to pass through the trust to beneficiaries. The trust is able to benefit from income splitting and the 50% CGT discount etc. but rather than the beneficiaries receiving an untaxed share of the net income of the trust they are now receiving franked dividend income.

The bucket company can still act as a beneficiary of the A Family Trust and then loan back the amount of the loan to the new operating company, allowing that amount to remain as working capital in the business. This will not be caught under Div. 7A. For asset protection reasons, this will be better than retaining earnings in the company as the operating company is likely to be sued and should therefore not be asset rich. Using the bucket company in this way means that the low-risk bucket company is asset rich instead. The loan taken by the bucket company should be secured, making the bucket company a secured creditor of the operating company.

Accordingly, if the operating company is sued as a result of its trading activities, then the bucket company will act as a secured creditor and have superior rights to all other unsecured creditors of the company. For a similar reason, the bucket company should be owned by a new discretionary trust (which offers some asset protection) and not by individuals who could be exposed to claims by creditors.



Post-restructure, the cost base of the shares held by the family trust in the new operating entity can be uplifted, which will also be of benefit when the operating company sells the shares in the new company, brings in third party investors etc. as this will reduce the amount of net capital gain on the sale of the shares at that point.[112]

The example above explains how the Subdivision 122-A roll-over can work in a tax effective manner and also be used to eliminate Div. 7A issues and create greater asset protection for the overall structure.

5.5 Division 7A of the Income Tax Assessment Act 1936 (Cth)

5.5.1 Introduction

As mentioned at 4.2.1, trusts are largely taxed on a flow-through basis, with the income of the trust allocated to beneficiaries who are taxed on their share of the trust income at their marginal tax rate. Where there is income of the trust that is not allocated to any beneficiary, it is taxed in the hands of the trustee at the top personal income tax rate

[112] Under s 122-50 of the ITAA 1997, the first element of each share's cost base is the sum of the market values of the precluded assets (i.e. depreciating assets) and the cost base of the other assets. In this example, the cost base for the shares will be the market value of the depreciating assets ($1.5 million) and the cost base of the other assets, being the goodwill in the business (nil cost base). The advantage of this situation is that even though the cost base of the assets held by the company are exactly the same as what they were in the A Family Trust there is now an uplift in the cost base of the shares held by the family trust in the newly incorporated company.

plus the Medicare levy. Accordingly, the trustee will generally allocate the income of the trust to beneficiaries to avoid paying tax at the highest rate. In practice this is why trust income is often applied to a bucket company beneficiary that has been set up to receive income, which will be taxed at the much lower corporate tax rate. The trustee must determine beneficiary entitlements by 30 June each year and by 31 August for capital gains. Losses however are not able to pass through a trust to beneficiaries.

While it is very common for a bucket company to be set up to receive trust distributions, in most cases, the trust does not actually pay the distribution out. This is what is commonly referred to as an 'unpaid present entitlement' or 'UPE'. The excess or retained profits are distributed to a corporate beneficiary and allowed to remain unpaid as a UPE. The trust can then use the income that it has retained, but that is owing to the company, to make tax free distributions to shareholders and their associates of profits in the form of payments or loans.

Division 7A of the ITAA 1936 is a provision which prevents these informal or disguised distributions to shareholders and associates who then use those payments for personal reasons i.e. to pay their personal debts coming out untaxed.[113] It is also intended to operate where a debt owed by a shareholder (or an associate[114] of a shareholder) of the private company to the trust is forgiven. The effect of Division 7A is to include these distributions of company profits in the assessable income of the shareholder or associate in the form of unfranked deemed dividends.[115]

Division 7A will not apply to tax the shareholder or associate in this manner if these loans are repaid or a loan agreement with minimum repayments is executed. A loan to a shareholder or associate will be caught unless it is made on 'commercial' terms as set out in s 109N of the ITAA 1936.[116] The agreement made in accordance with s 109N of the ITAA 1936 must be entered into before the earlier of the due date for lodgement and the date of lodgement of the trust's tax return for the year of income in which the loan is made. Without Div. 7A, individuals associated with the trust would have the incentive to divert their income into companies to access the lower tax rate whilst still being able to enjoy the benefit of the income.

However, the issue is that Div. 7A goes beyond this and also impacts upon reinvestment into the business that is being carried on through a trust. This can happen when a trust has income which it wishes to use for reinvestment, but in order to avoid the top marginal rate if the income remains in the trust, instead distributes the income to a company and is taxed at the corporate rate.

---

[113] A payment of a loan made or debt forgiven by a private company to a shareholder (or associate) is a deemed unfranked dividend to the shareholder (or associate): ss109C, 109D, 190F ITAA 1936.
[114] The term 'associate' is defined in s 318 of the ITAA 1936.
[115] An unfranked dividend equal to the amount involved (calculated under s 109XA(4)) is included in the shareholder's or associate's income.
[116] The criteria for compliant loans (for minimum interest rate and maximum term not being treated as dividends) are stipulated in s 109N of the ITAA 1936. They are as follows: (1) the agreement that the loan was made under is in writing; (2) the rate of interest payable on the loan for years of income after the year in which the loan is made equals or exceeds the benchmark interest rate for the year; (3) the term of the loan does not exceed 7 years, or 25 years if secured by a mortgage.

For nearly 12 years, practitioners thought they had a reasonable understanding of how Div. 7A operated. Then, at a presentation to the Taxation Institute of Australia on 10 February 2009, Deputy Commissioner Mark Konza publicly revealed what has come to be a fundamental change to the Commissioner's administration of Div. 7A.[117] The ATO's position is that this arrangement will fall within Division 7A.[118]

The ATO's view is that if the private company beneficiary has knowledge that funds representing its UPE are being used by the trustee of the trust for trust purposes and fails to call for the payment of its UPE, then Div. 7A will apply. Further, the ATO takes the view that where the trust and beneficiary form part of the same family group (which will be the situation with most family businesses), then the private company is considered to have the knowledge that the funds representing the UPE are being used for trust purposes or if they remain intermingled with the trust funds of the trust.[119] Currently, these views of the operation of the definition of loan apply to UPEs that arise on or after 16 December 2009 (the date the ATO's ruling was issued in draft form), however the proposed changes discussed below will have far-reaching implications.

In this situation, even though the trust is using the UPEs for business purposes, in order to avoid the operation of Div. 7A, a loan agreement must be entered into between the trust and the company. Division 7A requires loans to be offered at higher interest rates than those that would be commercially available to the business, and there are additional administrative costs involved in setting up these loans. Other options are for the trustee to create a sub-trust and the funds must be used for the sole benefit of a private beneficiary or to pay the amount to the beneficiary by the date of lodgement of the trust.[120]

This position can be contrasted with that of a business that is carried on as a company. A corporate structure is able to reinvest into the business by simply retaining its earnings and paying tax at the corporate tax rate on those retained earnings. In this way, businesses carried on through a trust wanting to reinvest are taxed at a higher rate (the top marginal rate) than businesses carried on through a company (the much lower company tax rate). Accordingly, with respect to reinvestment, Div. 7A creates a taxing point which does not arise for a corporate structure. The high tax rate for trusts that retain earnings pulls capital outside the business and disadvantages family groups operating through a trust structure.

---

[117] Set out in Taxation Ruling TR 2010/3 and the revised version of Practice Statement PSLA 2010/4 released in July 2011.

[118] TR 2010/3; *Tax Laws Amendment (2010) Measures No 2 Act 2010* (Cth).

[119] The *Tax Laws Amendments (2007 Measures No. 3) Act 2007* (Cth) introduced a new discretionary power which is able to be exercised by the Commissioner to provide relief in circumstances of Div. 7A applying as a result of an honest mistake or an inadvertent omission (s 109RB ITAA 1936). PS LA 2007/20 has been issued, which provides guidance as to when the Commissioner's discretion under s 109RB ITAA 1936 may be exercised. Payments or loans to interposed entities are captured as well as UPEs as between trusts in a multiple trust structures: ss 109XF, XG, XI.

[120] Sole benefit examples - The circumstances in which this will be so are explained in TR 2010/3 and in a practice statement issued on 14 October 2010 (PS LA 2010/4). The private company provides the trustee with financial accommodation and, by extension, makes a Div 7A ITAA36 loan to the trustee. the meaning of financial accommodation for the purposes the definition of loan in s 109D(3) ITAA 1936.

Example

The A Family Trust makes a distribution to A Pty Ltd (an associated bucket company) on 30 June 2018. The lodgement day for the A Family Trust is 15 May 2019. The trustee fails to pay the distribution to A Pty Ltd by 15 May 2019, set up a sub-trust for the sole benefit of A Pty Ltd by 15 May 2019, and enter into a Div 7A loan agreement. This will result in there being a provision of financial accommodation or in-substance loan made on 15 May 2019 and the UPE will be treated as an assessable unfranked dividend under Div. 7A.

Division 7A is seen as a significant disadvantage for those operating a family business through a trust. In this regard, Div. 7A can inappropriately reduce the resources available to a family business to be able to carry on and grow the business, and also to finance related family ventures. Business needs working capital to reinvest into the business.

During the roundtable discussions, Div. 7A was highlighted as a major issue and it was noted that billions of dollars are sitting in bucket companies, which will have to pay 'locked up tax'. It was also said by the advisers in attendance that clients are often unaware of this issue. The prevailing view was that Div. 7A has, over time, changed from being an anti-avoidance provision to an assessing provision. The main concerns expressed were:

- **Challenges in reinvesting into trusts**. With the Div. 7A loan interest rate being higher than the arm's length commercial rate;
- **Distinction between using profits for personal benefit versus for reinvestment**. The reinvestment point is that it is much more difficult and causes problems. It was noted that clients do not understand why there is a problem, as the money was reinvested into the business.
- **Unintended consequences**. Many within the ATO see a company as having a lower rate of tax and a trust as having access to the 50% CGT discount capital gain, and that a concessionary tax treatment for reinvested UPEs is a mixing of the benefits that was not intended. One adviser summarised the ATO view as follows: 'You either use your corporate vehicle and have a lower rate of tax and reinvest the profits, or you have a trust with a CGT discount which is not available for a company and pay a higher rate of tax'.
- **Div. 7A issues may result in restructuring**. Many clients don't realise they have a Div. 7A issue. Some issues may result in the next generation having to deal with them.

The consensus was that rollover provisions are now commonly being used to restructure where Div. 7A issues have become a significant problem. It was noted that a long-term strategy is required to deal with Div. 7A as part of effective succession planning. One solution proposed by the roundtable advisers was for Div. 7A to be amended so that the rules do not penalise private business loans where the borrowing entities are entitled to claim an income tax deduction for servicing such debt: an 'otherwise deductible rule'.

5.5.2. Proposed Changes to Div. 7A

The proposed new Division 7A regime draws upon a number of recommendations from the Board of Taxation's *Post Implementation Review* into Division 7A.[121] The Review recommended a model called the 'Amortisation Model', under which loans would be repayable over a 10-year period and have reduced documentation requirements as well as greater flexibility in repaying interest and principal.[122] The proposed Amortisation Model extended to pre-1997 loans and pre-2009 UPEs, as well as post-2009 UPEs and complying seven-year loans — whilst complying 25-year loans were to be grandfathered.[123] Notably, the Amortisation Model proposed a carve-out to assist trading trusts wishing to reinvest profits as working capital, called the 'business income election' exemption. The proposed exemption was that UPEs owed to corporate beneficiaries would not be subject to Div. 7A if the trustee agreed to forgo the CGT discount concession on assets other than goodwill.[124]

The Treasury Consultation paper released on 22 October 2018, *Targeted Amendments to Division 7A*,[125] includes the following distinct features:

- implementation of the single 10-year loan model;
- no amortisation, meaning there must be an annual principal and interest payment;
- the benchmark interest rate has been increased from the housing rate to the overdraft rate (an increase of over 3%);
- no grandfathering of 25-year loans;
- no business income election;
- removal of 'distributable surplus'; and
- extension of the assessment review period for Division 7A amendments to 14 years.

Originally, the 'targeted amendments' announced in the 2016 Federal Budget were to take effect from 1 July 2018, requiring 2010 UPEs maturing in 2018 to be dealt with. To this end, the ATO released Practical Compliance Guideline 2017/13 (PCG 2017/13), which allowed UPEs maturing in the 2017 or 2018 years to be 'rolled' onto 7-year section 109N compliant terms. However, the commencement date for the reforms was deferred to 1 July 2019 in the May 2018 Federal Budget, resulting in PCG 2017/13 being amended to cover UPEs maturing in 2019.

The advisers at the roundtable discussions expressed a number of concerns with respect to the proposed changes to Div. 7A. The consensus was that the biggest concern was with respect to pre-1997 UPEs that have been 'forgotten about'. The increase in the Division 7A interest rate, and the fact it is significantly higher than the market interest rate,

---

[121] Board of Taxation, Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936 (November 2014).
[122] Ibid, viii.
[123] Ibid, 23.
[124] Ibid, Chapter 8.
[125] The Australian Government the Treasury, *Targeted amendments to the Division 7A integrity rules* (October 2018).

was also highlighted. One adviser noted that this will impact a number of Div. 7A strategies dramatically. Another concern was the fact that 25-year Division 7A loans, to the extent to which they exist, will be reduced to 10-year loans and cause cash flow issues. The possible repayment of these loans being funded from the working capital of the business was regarded as a major concern. Finally, there were queries as to how loans that were 'frozen' due to distributable surplus in the past will be treated.

Example

Before 2009, a trust made a profit of $10 million and distributes, but does not pay, the income to a corporate beneficiary. The corporate beneficiary has an asset being a receivable of $10 million and retained earnings of $10 million. If the proposed changes are implemented, the 'locked up tax' will have to come out over a 10-year period (effectively as a dividend) and likely be sourced from working capital. This would be a major impediment on the business.

5.5.3 Recommendation

The law must achieve an appropriate balance between supporting businesses and maintaining the integrity of Australia's tax system. Division 7A was introduced to maintain the integrity of Australia's tax system by preventing informal or disguised distributions to shareholders and associates who then use those payments for personal reasons coming out untaxed. However, the law has been interpreted by the ATO in such a manner that it applies to UPEs that are reinvested back into the business. This appears to be going beyond the original policy objective of Div. 7A and is adversely impacting upon the cash flow of business and also increasing compliance costs for business. Further, the proposed changes to Div. 7A are likely to make things even more difficult for businesses carried on through a trust.

In order to support businesses while still maintaining the integrity of Australia's tax system, it is recommended that Div. 7A be amended so that the rules do not apply to private business loans where the borrowing entities are entitled to claim an income tax deduction for servicing such debt – an 'otherwise deductible rule'. This amendment will mean that if the family trust uses UPEs for business purposes, then provided that loan is on commercial terms, Div. 7A will not apply. This will more closely align the tax treatment of retained earnings in a corporate structure with that of a trading trust structure. Given that any amendments to Div. 7A will have the greatest impact on small business and family enterprise, to avoid any unintended consequences, it is recommended that the small business and family enterprise sector is consulted prior to any draft bills being released.

5.6 Section 100A of ITAA 1936

An interesting question is whether Section 100A of the ITAA 1936 dealing with reimbursement agreements could be applied in the classic UPE situation described above. Section 100A is an anti-avoidance provision in the ITAA 1936 which enables the Commissioner to assess the trustee on the trust's net income if the Commissioner forms the opinion that the manner in which income has been distributed, and the arrangements in place between the trustee and the beneficiaries that have received trust distributions is a 'reimbursement arrangement'. A 'reimbursement arrangement' will occur when the trustee has distributed the income of the trust to a beneficiary, however that distribution will be for the benefit of another party, including the trustee itself.

This may arise in a family trust where there is a UPE and the funds representing that entitlement are paid or loaned to another party, or when longstanding UPEs are not being paid down. The key exception to the application of Section 100A is when the arrangement can be characterised as an 'ordinary family or commercial dealing'. The ATO has published guidance material which expresses the Commissioner's view on what does and does not constitute an 'ordinary family commercial dealing'.

The meaning of ordinary family or commercial dealing is not defined, and in the ATO's view, relies upon an analysis of the relevant facts, having regard to all the steps comprising the relevant agreement, not merely components of it.[126] Any arrangement deemed an ordinary family dealing, ordinary commercial dealing, or family commercial dealing does not fall within the ambit of s 100A.

Example of Ordinary Commercial Dealing[127]

The A Family Trust is a discretionary trust controlled by Mr. A and administered for the benefit of Mr. A and his family. It was established in 2010. The A Family Trust carries on a business and has distributable and taxable income in each year. The trustee of the A Family Trust makes A Co Pty Ltd (a bucket company), an Australian resident company owned by Mr. A, presently entitled to the trust's distributable income. The A Family Trust ensures that all entitlements of A Co Pty Ltd are placed on Div. 7A complying loan terms or sub-trust arrangements that comply with the options in PS LA 2010/4 (with annual repayments made over seven or 10 years). The trustee uses the funds as working capital for the business. Where the funds are lent back to the trust under a Division 7A complying loan and retained in the trust as working capital (and in the absence of other factors that take this arrangement outside of that which would be considered to be an ordinary commercial dealing), the Commissioner of Taxation would not consider this arrangement to be a reimbursement agreement.

The ATO considers arrangements where a loan from a beneficiary to a trust is a complying loan under Div. 7A (or a UPE held on complying terms) to be in the course of an ordinary commercial dealing. Furthermore, the ATO provides that:[128]

- The ATO has not sought to apply Division 7A to mere unpaid entitlements created before 16 December 2009. The ATO will also not devote compliance resources to the application of section 100A to these entitlements where the relevant funds are retained as working capital of the trust.

[126] Ibid 3.
[127] Ibid 4.
[128] Ibid 6.

- Where Division 7A applies to an unpaid entitlement created on or after 16 December 2009 and the retained funds are used as working capital of the trust, the ATO will not generally seek to devote compliance resources to considering the question of whether or not section 100A would also apply to that arrangement.

5.7 Trust Losses

5.7.1 Discretionary trusts

Trusts can only deduct tax losses in limited circumstances pursuant to the restrictions contained in Schedule 2F of the ITAA 1936 which was enacted to prevent the transfer of the tax benefits of those losses to entities that did not bear the economic loss in the loss year. For a discretionary trust, there are three relevant tests which must be passed in order for a trust to deduct current or prior year losses. These include:

- The pattern of distributions test;
- The control test; and
- The income injection test.

The only exception to this is where a discretionary trust has made a Family Trust Election (see 5.8). The only trust loss rule applicable in this situation is a modified income injection test.

Pattern of distributions test

Broadly, the pattern of distributions test is satisfied if the trust has distributed, directly or indirectly, more than 50% of the income and capital (if any) to the same individuals for their own benefit in every 'test year distribution' — being the earliest year prior to the loss year in which income was distributed, and the year in which a distribution is made following the loss year. The test only applies if distributions of either income or capital are made in the income year in which the loss is to be deducted, and in at least 1 of the previous 6 earlier income years.[129]

If the trust does not distribute the same percentage to each individual in every test year distribution, then the smallest percentage distributed to that individual is taken to be the percentage distributed to that individual for each of the relevant years.[130]

[129] Schedule 2F, s 267-30 ITAA 1936.
[130] Schedule 2F, s 269-70 ITAA 1936.

Example

The Loss Trust is a discretionary trust and has not made a Family Trust Election. A tax loss was incurred by the Loss Trust in the 2017/18 financial year. The trustee of the Loss Trust distributed income in the 2016/17 financial year and 2018/19 financial year as follows:

Family member	2016/17	2017/18	Minimum percentage
Mum	80%	20%	20%
Dad	10%	10%	10%
Daughter	10%	35%	10%
Son	0%	35%	0%
TOTAL	-	-	**40%**

As the total minimum percentage of test distributions of income is 40% — less than the required 50% — the pattern of distributions test is not satisfied. As is evident in the example above, the pattern of distributions test is difficult to satisfy in situations where trust beneficiaries receive different percentages of trust net income from one year to the next, which could arise in a multitude of family tax planning situations — particularly where a large family group benefits under the trust.

Control test

The control test requires that no 'group' (being a person and their associates) begins to control the non-fixed trust (i.e. discretionary trust), whether directly or indirectly in the test period. Generally, the control test will be activated where the trustee and/or appointor is changed as to benefit a new family group — which may also involve the amendment of the trust deed or appointment of new beneficiaries. Essentially, a group is taken to control a non-fixed trust if:

- they control the trustee of the trust;
- are able to ensure the exercise of a trustee discretion in their favour;
- become the appointor of the trust; or
- gain a fixed entitlement to more than 50% of the income or capital of the trust.

The Commissioner has a discretion to deem that a group has not begun to control a trust, where having regard to all the circumstances it is reasonable to do so.

Income injection test

The income injection test prevents the trust from having income injected into the trust by an 'outsider'. For a discretionary trust that is not a family trust, an 'outsider' is a person other than the trustee of the trust or a person with a fixed entitlement to income or capital of the trust.[131]

5.8 Family Trust Elections

5.8.1. Introduction

The trustee of a trust may make a Family Trust Election (FTE) that the trust is a family trust for the purposes of the ITAA 1936 and ITAA 1997.[132] Interposed Entity Elections are similar.[133] It is an election made for tax purposes and is often made to access trust losses, for passing franking credits to beneficiaries, or to access the Subdivision CGT business restructure section 328-G roll-over. These benefits of making a FTE are discussed below. A FTE is generally irrevocable (subject to certain exceptions) and therefore, its implications will continue to apply whilst the trust exists. The first step is for the family trust to nominate an individual (the test individual) as the individual whose family group is to be taken into account in relation to the FTE. The diagram below represents the family group – you can see that the test individual sits at the centre of that group. All family trusts with FTE nominating same test individual are within the Family Group.

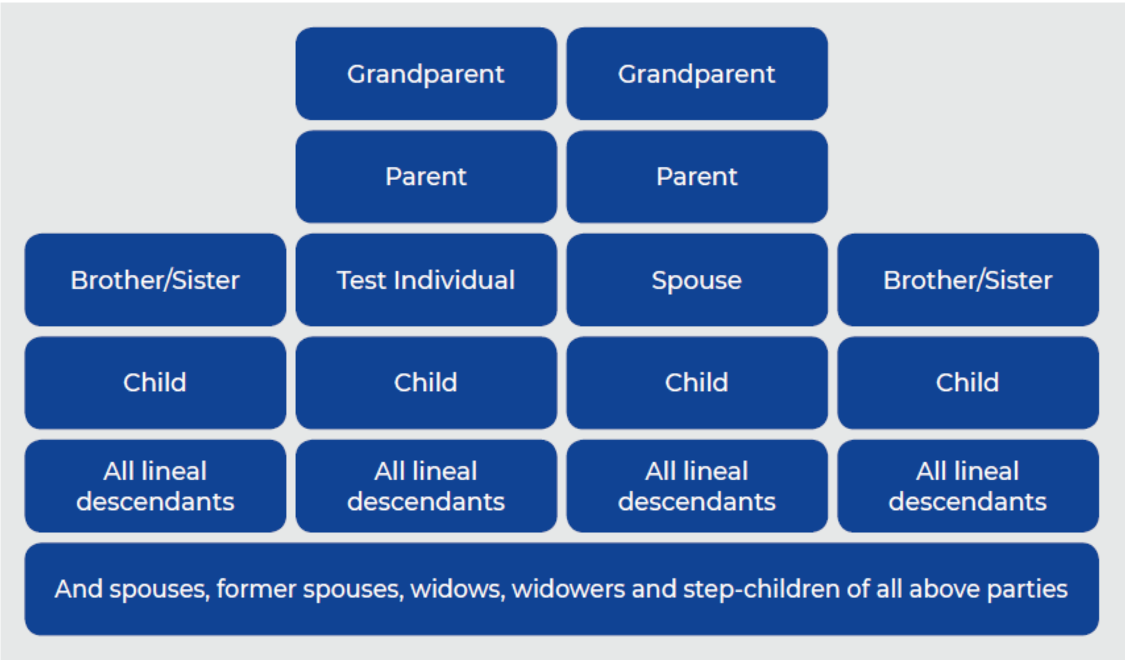


Diagram 7: Family group with nominated test individual

[131] Schedule 2F, s 270-25 ITAA 1936.
[132] Schedule 2F, s 272-75 and 272-80 ITAA 1936.
[133] Schedule 2F, s272-85(1) ITAA 1936.

Taxpayers may lodge a FTE or an IEE with retrospective application provided that a control test can be satisfied during that period of time.

The most significant negative consequence of making an FTE is that it limits the tax-effective streaming of the income or capital of the trust. Any conferral of a present entitlement or distribution to a person outside the test individual's family group will be subject to family trust distribution tax (FTDT), which is payable by the trustee at the top marginal rate of tax plus Medicare levy.

Furthermore, s 272-60 ITAA 1936 extends the meaning of 'distribution' for the purposes of family trusts to include:

- payments (including by way of loan);
- transfers of property or right to use property;
- dealings with property; and
- debt forgiveness or waiver

for the benefit of a person, to the extent that the amount paid, credited, reinvested or applied, the value of the property transferred, or the value of the other thing done not on arm's length terms.

Relevantly, the ATO has released TD 2017/20, which contains the Commissioner's view on who may be entitled to a 'distribution' as described under s 272-60. The provision had previously been thought to only apply where the relevant dealing involved a beneficiary of the trust — however, the Commissioner's view expressed in TD 2017/20 now purports to extend the application of s 272-60 to non-beneficiaries. Considering this view, where a family trust has dealings with third parties that are not on arm's length terms, there is potential for a FTDT liability to arise. In the context of a business being operated through a trading trust, the Commissioner acknowledges that a distribution will not occur where a transaction is part of ordinary business dealings.

The general consensus at the roundtables was to hold off as long as possible before making a FTE as it can pose issues when it is attempted to include an outside party into a structure. From a succession planning perspective, the advisers noted there may be challenges where there is a large group.

5.8.2. Access to Franking Credits

One of the primary reasons for making a FTE is to access franking credits. For shares acquired after 31/12/1997 the beneficiary will be denied the benefit of imputation credits unless either: (a) the total of imputation credits attaching to all dividends to which the beneficiary is entitled in respect of shares held directly or indirectly by the beneficiary or by the non-fixed trust do not exceed $5000; or (b) the non-fixed trust has made a FTE. If a FTE is made then franking credits can flow through.

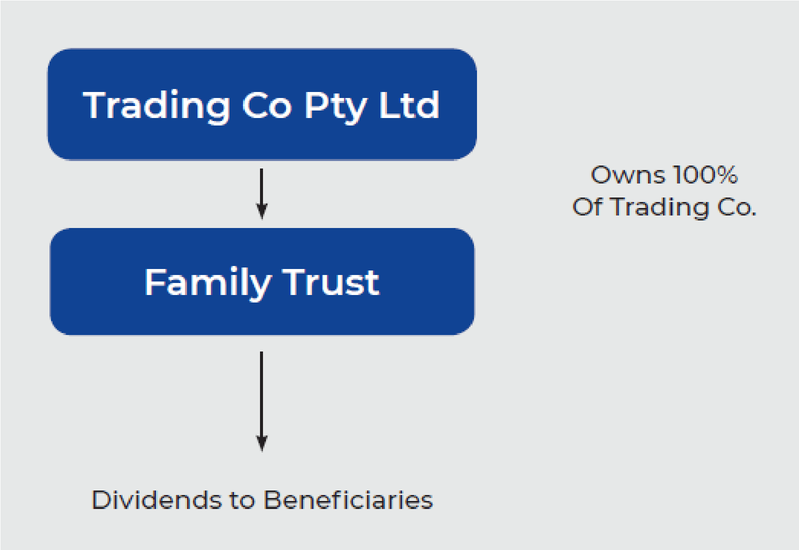


Diagram 8: FTE made to access franking credits

5.8.3. Accessing Trust Losses

Another benefit of making a FTE is so that trust losses can be accessed. Where a discretionary trust has made a FTE, the only trust loss rule applicable in this situation is a modified income injection test (so, the tests in 5.7 above will not be relevant). The modified income injection test only prevents individuals and entities that are not part of the 'family group' from injecting income into the trust. The family group includes interposed entities that have made an interposed entity election. As such, family trusts are commonplace where a potential loss-making trust — such as a trading trust — is used in a business structure.

As a FTE can be made retrospectively, if a trust makes a FTE, it can carry forward its losses from a loss period to a profitable period and offset those losses against the profits during the profitable period.

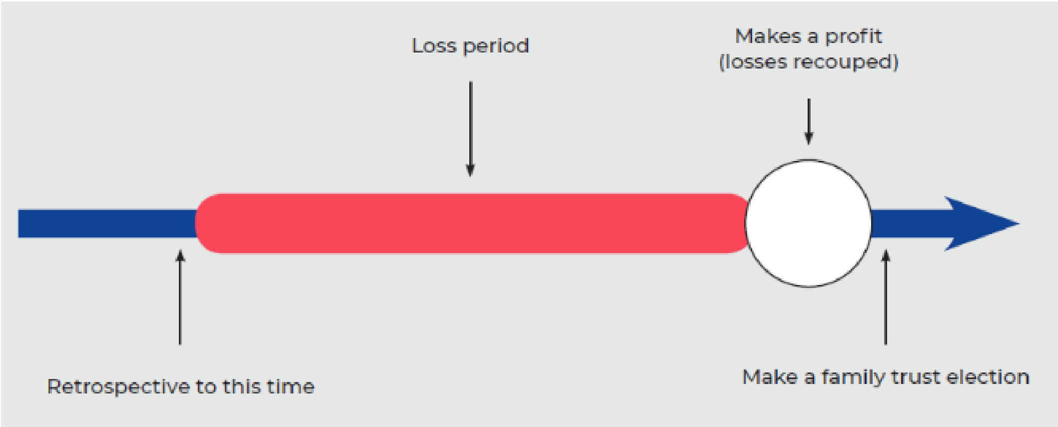


Diagram 9: FTE made retrospectively

Further, multiple trusts owned by the family group can make FTEs, and provided that both trusts choose the same test individual, then distributions can be made from the income trust to the loss trust.[134]

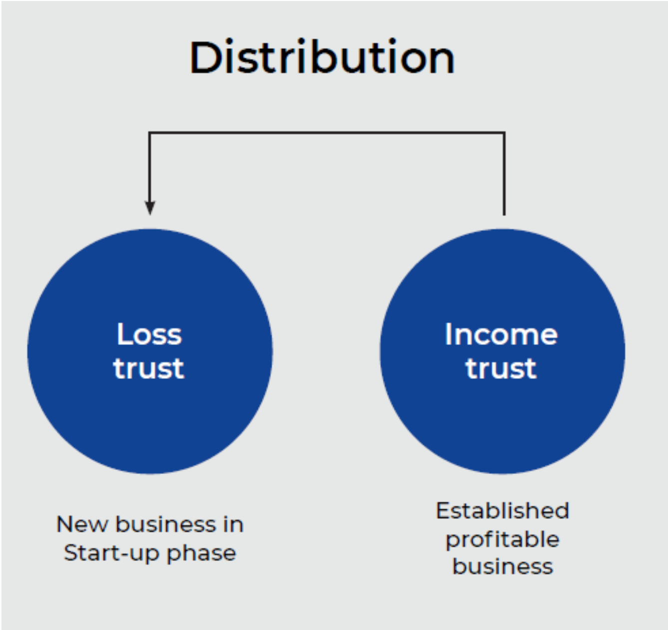


Diagram 10: FTE made to access trust losses in Loss trust

5.8.4. Division 328-G roll-over

Following the federal government's jobs and small business package introduced during the 2015-16 federal budget, Subdivision 328-G was enacted to provide small business owners flexibility when they choose to restructure their businesses structure without incurring a capital gains tax liability at the time of the restructure. The test under Subdivision 328-G of the ITAA 1997 for ultimate economic ownership is only available to discretionary trusts that have made a FTE. To meet the test, every individual that has ultimate economic ownership of the transferred asset must be a member of the family group relating to the family trust.

The advisers at the roundtables noted that Division 328-G of the ITAA 1997 rollover relief has been a major reason for making FTEs. For example, in order for a general manager to buy-in to a business, a business restructure may involve setting up a holding company to strip retained earnings out of business, using a number of rollovers including the Division 328-G of the ITAA 1997 rollover.

[134] Schedule 2F, s 272-80 of the ITAA 1936.

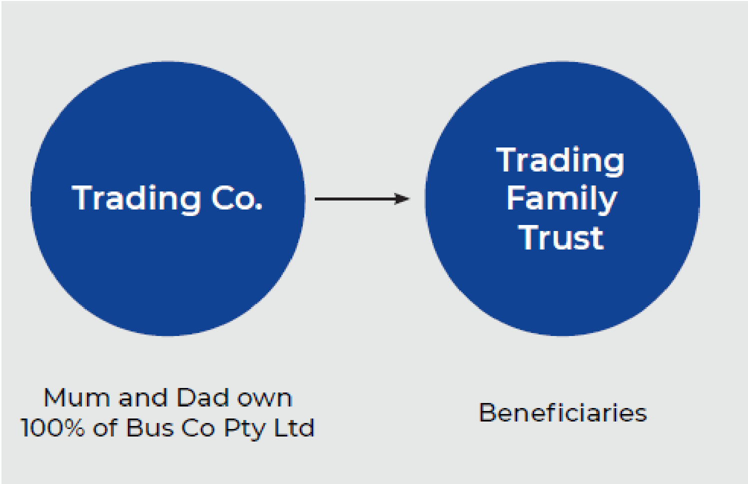


Diagram 11: Restructure after FTE made to access Division 328-G rollover

5.9 Trust Vesting

5.9.1 The Rule Against Perpetuities

The rule known as the rule against perpetuities was developed by the English courts several centuries ago. It applies to family trusts to limit the life of the trust and the effect of the rule is that by the vesting date, the trust fund must be absolutely vested in the beneficiaries. The vesting date at common law was referenced to the life of a person living at the date of the creation of the trust plus a further period of 21 years. As the English Privy Council explained in a 1999 decision:

> [N]o interest is valid unless it must vest, if it vest at all, within a period of a life in being, the date of the gift plus 21 years. The rule is applied remorselessly. A gift is defeated if, by any possibility, however remote, it may vest outside the perpetuity period. It is not saved by the fact that, in the event, it vests inside the period.[135]

This is why older trust deeds often describe the vesting date of the trust as 'That day which is 21 years after the date of death of the last to die of the descendants of King George V living at the date of this trust deed'.

The rule of perpetuities has been abolished in South Australia,[136] however it has been enacted into law in all other Australian jurisdictions. Most states and territories provide for a period of 80 years or for the trust to specify a period of 80 years or less.

The rule against perpetuities can place a significant tax burden on a family business as it creates a taxing point at the vesting date. On that date, the assets of the trust must be transferred to a different owner. The most significant tax

[135] *Air Jamaica Ltd v Charlton* [1999] 1 WLR 1399, 1408-1409.
[136] While the rule has been abolished in South Australia, this is subject to the jurisdiction of the Supreme Court of South Australia to order vesting: ss 61 and 62 *Law of Property Act 1936* (SA).

consequence is likely to be CGT which may be payable on the capital gain generated from assets that have appreciated in value over multiple generations.[137] This may require beneficiaries of the trust to find the cash to pay the tax liability which has the potential to significantly impact on the ongoing viability of a family business. The rule against perpetuities has been referred to in the Senate Report submission as 'a ticking time bomb from a family business perspective'.[138] In addition to CGT issues, the transfer of assets can result in stamp duty being payable as well as the family business owners having to incur costs in the restructure of the business.

The advisers at the roundtable sessions noted that, while the rule has been abolished in South Australia, there are instances where trust deeds specify a vesting date in which case the same issues arise. With respect to the application of the rule in South Australia, the ATO view is that a variation to the vesting date of the trust before vesting is acceptable, however a variation to the vesting date of the trust after the date has passed will be ineffective.

Another issue raised at the roundtables with respect to vesting is where a trust holds assets across multiple jurisdictions and in these situations the residency of the trust may not be clear. Accordingly, what has been considered to be a South Australian trust may actually be a resident in another Australian jurisdiction and in these cases the rule will then apply to the trust.

5.9.2 Recommendation

The rule against perpetuities has the potential to create significant problems for businesses structured as a trust. The vesting date brings with it a taxing point that can create significant financial stress for a business, which is then encumbered by tax liabilities and restructure costs, simply because the trust deed has set a vesting date for the trust. This rule is most likely to impact on family businesses where the control of the trust has passed from one generation to another. The next generation is unlikely to be aware of the taxing point coming up in the future, which can impact on cash flow and even the ongoing viability of that business. The policy reasons for this rule coming into existence clearly do not align with the concept of a trading trust structure. Accordingly, in the trading trust context, this rule is not fit for purpose.

It is recommended that the rule against perpetuities be abolished in each Australian jurisdiction, or alternatively, that its operation be limited so that commercial arrangements are not included within its scope. Given that South Australia has already abolished this rule, jurisdictions outside of South Australia can look to South Australia to determine the effect that the abolition of this rule has had on trading trusts in that jurisdiction.

At the very least, if there is no appetite to abolish or amend the rule in these jurisdictions, there needs to be some education around how the rule works and the likely financial impact on the trading trust at the vesting date. This will

---

[137] The occurrence of CGT events A1, E5 or E7 in particular

[138] Parliamentary Joint Submission on Corporations and Financial Services, *Family Businesses in Australia – Different and Significant: Why they Shouldn't be Overlooked* (March 2013) p 179.

give the owners of the business the opportunity to seek professional advice so that they can avoid the operation (and potential negative impact) of the rule.

5.10 Business Succession

5.10.1 Introduction

Past research, as well as views expressed by the advisers present at the roundtable discussions, clearly suggest that succession is one of the key challenges that families in business face. Research suggests that 70% of wealth transfers amongst family businesses fail within three generations due to three key reasons: (1) a lack of communication and trust among family; (2) a lack of a shared purpose among the family as to how family wealth should be used in the future; and (3) a failure to prepare the next generation for the responsibilities that come with wealth.[139]

Many business families will face the challenge of wealth succession in the near future, with an estimated $3 trillion of family wealth expected to transition ownership in Australia over the next 10 to 20 years as the Baby Boomer generation pass on their wealth to others.[140] This long anticipated 'great wealth transfer' is already well underway.

Succession is more than about who will take over running and owning and/or controlling the family business. In fact, succession planning involves a series of separate but related plans[141] including:

- **A retirement plan** – When the current controllers/owners will step down from management of the business, their financial requirements, and how this will be met (income from investments, distributions from the business);
- **An exit plan** – Takes into account the retirement plan and identifies the different exit options available to achieve this while taking into account the needs of other family members;
- **A management succession plan** – If the exit plan involves keeping the business in family control, then the next part of the succession plan is determining the criteria and process for appointing individuals to take over the running of the business;
- **An equity succession plan** – If the exit plan involves keeping the business in family control, in addition to management succession, it is also important to determine who within the family will have ownership and/or overall control of the business;
- **Estate plans** – Once the succession plan has been determined it will need to be incorporated into the estate plans of the current owners/controllers.

---

[139] Brad Simmons, 'Why 70% of Wealth Transfers Fail', Mutual Trust, 2014. Available at https://www.mutualtrust.com.au/families/70-wealth-transfers-fail/.
[140] Mark Smith, 'Largest Intergenerational Wealth Transfer to Come', *Financial Review* (online, 6 December 2017) <https://www.afr.com/news/special-reports/portfolio-diversification/largest-intergenerational-wealth-transfer-to-come-20171205-gzz6cg>.
[141] Sue Prestney, *Family Business Succession Guide* (Thomson Reuters, 2014).

Legal structures used by a business have a significant influence over the manner in which succession is carried out. Provided a family is functioning well, the use of family trusts can be a useful wealth and estate planning tool, primarily due to the flexibility that family trusts provide. With respect to succession of a business, there are two points in time in which this can occur: the first is prior to the death of the owners of the business and the second is after the death of the owners of the business. The succession plan will differ depending on whether the succession of the business occurs before or after the death of the business owners.

5.10.2 Pre-Death

Prior to the death of the owners of the business, generally being mum and dad in a family business context, the transfer of ownership of the business may occur for a number of reasons. The parents may wish to retire from the business, or the situation may also arise when the children who have been working in the business for many years ask for an ownership interest in the business. The owners can either sell the business to a third party or pass control of the business to their children. The succession plan will involve the transfer of the equity in the business and of the control of the business to a third party or to their children.

If the business is sold to a third party, the business may need to be restructured ready for sale. For example, it may be restructured from a trust into a company structure and then there may be a share sale to the third party. The owners of the business may be entitled to a number of capitals gains tax concessions which may result in them exiting the business tax free.

Another option is to pass control of the business to the next generation. In some instances, this may be easy. One adviser at the roundtable discussions noted a recent example involving a trading trust with a corporate trustee (company) run by a mother and father who handed the business down to their son. The transfer of the business to the son was seamless: they appointed the son as the appointor of the trust, transferred the shares in the corporate trustee, and changed its directors all without any tax consequence.

The consensus view was however, that there is limited ability to pass assets down whilst the controller of trust is still alive i.e. where the children want the money ‘now’ or an ownership interest ‘now’ given they have contributed to the business. It was agreed that this is a significant limitation of family trusts. One adviser noted that in the past year they have seen a number of transactions where there are significant asset transfers from parents to children that have resulted in the parents being bereft of any economic sustenance. In these situations, it was noted that the children are generally not giving arm’s length (or *any*) consideration for these transfers – they are ‘gifts’. One adviser noted that many difficulties arise where parents are financially dependent on their children – and it causes relationship breakdowns. The case of *Rodda v Ian Rodda Pty Ltd*[142] and its implications were discussed.

---

[142] [2015] SASC 95 (‘*Rodda*’). The father lost his appeal against the judgment: *Rodda v Ian Rodda Pty Ltd* [2015] SASC 128.

In *Rodda*, the South Australian Supreme Court held that a farmer operating his farming business through multiple family trusts (of which his company was corporate trustee) was required to reinstate his son's equitable interest in his valuable farming land and other associated farming assets. The son had been cut from the father's will following a dispute in 2012 after more than 18 years working together. The son successfully sought to enforce his pre-existing equitable interest in the farming land and associated assets on the basis of estoppel given that his father had during their long working relationship made several representations regarding his intentions for the son to eventually 'take over' the business. The court held that the father held his farming land and associated assets on constructive trust for his son and was deemed to have done so since 1 December 2012.

The issue of whether the parents would be eligible to receive the aged pension once they relinquish their interest in the trust in this manner was also raised at the roundtable discussions. Once the business has been transferred to the next generation, the parents may rely on the aged pension and the children are then left to control and operate their family trust. It was noted that it is extremely difficult to be entitled to a pension under the current law in that situation. It was put forward by one adviser that there may be hundreds of thousands of people who are receiving a pension who are not actually entitled to them.

The advisers also discussed the situation where control of the trust is bequeathed to multiple parties who have conflicting interests and the assets of the trust are illiquid and must be sold. It was noted that this is primarily an issue where there are multiple children or families involved.

One adviser noted that the addition of one family member or spouse can change the family dynamic completely. It was said that the 'defining feature of a trust is flexibility, and it can cut both ways'. Where there is one controller of the trust it works brilliantly, but where there are multiple controllers there is generally difficulty. In these situations, the transfer of ownership and control can be very complex, involving a restructure of the business and even a sell off of part of the business, resulting in prohibitive CGT issues that could lead to an erosion of the businesses' asset base. It could even create considerable cash flow issues for the business, potentially impacting on its ongoing viability. In this event, the owners may be forced into selling their interest to a third party rather than passing the business onto the next generation in order to avoid the tax consequences.

A further limitation identified by the advisers was in determining 'who they are acting for' when they have always acted for the family unit but then there is a conflict within that unit.

5.10.3 Post Death

The assets of a family trust do not form part of the estate of a deceased person and therefore cannot be transferred under the deceased owner's will. With respect to the trust assets, the controller of the trust (usually the owner of the business) does not actually own anything. All they are doing is simply controlling the trust for the benefit of the beneficiaries. Further, no beneficiary to a discretionary trust is entitled to the trust assets as all they have is a right to be considered for a distribution from the trust by the trustee. Therefore, the controllers and beneficiaries of a trust cannot pass family trust assets through their will.

The trust deed of a trust will set out how a change of control is to occur on the death of the controller of the trust. Usually this can occur through the appointment of a successor appointor in the will of the deceased owner. The owner's will will also then provide for a successor appointor, which is generally the child or children of the owner. In this way, the children will control the trust following their parents' death in a similar manner to what would have occurred if the assets were passed directly to the children under their parents' will.

As explained at 1.2.6, quite often, in addition to the successor appointor direction in a will of the owner, the owner's solicitor will draft a letter of wishes which is annexed to the will and sets out the owner's wishes with respect to how the business will be operated after their death. Such indications may be incorporated into the trust deed itself, or documented in a separate (generally confidential) 'letter of wishes' appended to the trust deed. The letter of wishes is sometimes referred to as the 'memorandum of wishes'. Again, this document is not legally binding though the trustee may take it and the views of the beneficiaries into account in exercising their discretions under the trust deed.[143]

From an estate planning perspective, it may be difficult to pass assets to the next generation if they are held in a family trust. In this regard, if the owner of the business has three children and passes control of the trust onto the children, then all three children will control all of the trust assets at the time of the owner's death. The children do not have a separately identifiable interest in the trust; all three are simply controllers and beneficiaries of that trust. This provides the children with flexibility as to how they wish to deal with the trust assets and also provides asset protection. For example, if the children require funds for a specific purpose, a distribution of income or capital of the trust can occur, or the trust can make a loan to the children being secured over any asset purchased. Further, if any of the children divorce from their spouse, encounter financial difficulties, or are sued by creditors (i.e. one child may be in a high-risk profession such as a doctor or lawyer), then the trust assets will not be exposed.

This can be contrasted with a business that is carried on through a company where each child can receive an equal proportion of the issued shares in the company from their deceased parents. As the owner of those shares, the children have an identifiable asset they are each able to sell. However, if the shares are bequeathed to them personally, they are exposed to sale and distribution by creditors or the Family Court.

One issue raised at the roundtable sessions concerned businesses that are carried on through structures where the trading entity is separated from the entity holding the passive assets of the business (such as land). In this scenario, there is 'one highly valuable asset (land), without which the business cannot operate, and these are often businesses that have gone on for many generations'. It was noted that in this situation, it is significant to consider succession planning and exercising control over what happens to such an asset. A common example that was cited concerned

[143] *Hartigan Nominees Pty Ltd v Rydge* (1992) 29 NSWLR 405; *Monaghan v Monaghan* [2016] NSWSC 1316.

which child in a farming family takes control of land. It was noted that primary production is an outlier to some degree due to the multigenerational nature of the business; the parties are concerned with the control of the asset (the land).

One adviser at the roundtable sessions noted that family trusts are not good at dividing wealth where the parties do not ‘get on’ with one another. The adviser cited a recent example where the assets of the trust had to be sold, resulting in CGT issues. Another example mentioned was of a person with a trust who left control to his three daughters (as directors of the corporate trustee). Inevitably, the daughters did not agree with how the estate should be divided, and consequently any two daughters could cut out the third by calling a meeting and resolving to remove her as director. One adviser also mentioned that shareholders of a company have certain protections under the *Corporations Act 2001* (Cth) (e.g. shareholder oppression) which are not available to trusts.

The advisers discussed that in these cases of conflict between the children, one of the children may be given control of the trust and the other children might then be compensated through receiving more out of the estate of the owner when they die. One adviser referred to an example where a mother owned a business and the son wanted ownership. Control of the trust was transferred to the son and his share of his mother’s estate was equalised so that the daughter’s share of the mother’s estate was larger. However, it was noted that the extent to which this is effective is subject to the will staying the same, meaning a significant amount of trust between the parties is required.

5.11 Research & Development

The Research and development (R&D) tax incentive encourages companies to engage in R&D by providing a tax offset for eligible R&D activities. Eligible entities can receive the following tax incentives: a refundable tax offset for certain eligible entities whose aggregated turnover is less than $20 million, and a non-refundable tax offset for all other eligible entities.

You can only claim an R&D tax offset if you are an R&D entity. R&D entities include companies that are:

- incorporated under an Australian law;
- incorporated under a foreign law but are Australian resident for income tax purposes;
- incorporated under a foreign law and are both (1) a resident of a country with which Australia has a double tax agreement that includes a definition of 'permanent establishment'; and (2) carrying on business in Australia through a permanent establishment as defined in the double tax agreement.

Entities that are *not* eligible for an R&D tax offset include:

- an individual;
- a trust (with the exception of a public trading trust with a corporate trustee);
- a corporate limited partnership; and

- an exempt entity (where your entire income is exempt from income tax).

Advisers at the roundtable sessions noted that a business carried on in a trust may restructure in order to access certain grants and subsidies, such as the research and development (R&D) concessions under the tax law, as these concessions are only available to businesses carried on through a company.

5.11.1 Recommendation

A business carried on through a trust that is engaged in R&D is not eligible to receive the tax offset for its R&D activities. In order to access the concessions, the business must restructure into a corporate entity, which can result in tax liabilities as well as costs of restructuring. It is recommended that all entities, irrespective of their business structure are eligible for the R&D tax offset providing that they meet all other eligibility criteria for the tax offset.

5.12 Trust Resettlements

A trust resettlement can occur when variations to the trust deed of the trust are made, resulting in a new trust being created. The ATO Statement of Principles provide a list of possible changes to a trust which may result in a new trust being created.[144] These include:

- any change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a possible redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature or features of trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of the trust property;
- a change in the termination date of the trust;
- a change to the trust that is not contemplated by the terms of the original trust;
- a change in the essential nature and purpose of the trust; or
- a merger of two or more trusts or a splitting of a trust into two or more trusts.

Advisers at the roundtable discussions expressed concern that if variations are made to an old trust deed to modernise that deed that this may result in a trust resettlement which can result in significant tax liability to the trust. In

[144] ATO, Creation of a new trust - Statement of Principles, August 2001.

particular, this can result in capital gains tax[145], income tax[146] and stamp duty liabilities. It can also result in the tax characteristics of the trust being lost, such as the ability to carry forward losses of that trust.

5.12.1 Recommendation

Trust deeds are often amended and many of these amendments can result in the resettlement of the trust, creating an unintended but significant taxing point for the business. This could lead to an erosion of the businesses' asset base, or create considerable cash flow issues for the business, ultimately impacting on the ongoing viability of the business. It is recommended that small business and family enterprise and their advisers be consulted to determine in which situations trust deed amendments are required either to modernise the trust deed or to accommodate the various stages of the lifecycle of a business. The law should be amended to allow for these variations to the trust deed of the trust without creating any taxing point. Such a measure will need to ensure that the integrity of the tax system is not undermined.

5.13 Integrity Measures

Trusts are seen as potential 'anti-avoidance' vehicles. One adviser at the roundtable discussions mentioned that the ATO and Revenue SA 'stick to their mandate of collecting tax' and therefore dislike trusts given that they may be used to minimise tax liability. Since the early 1990s there have been a number of amendments to the law aimed at discouraging the use of trusts as a tax planning opportunity. Those that relate to the family business context include:

- Insertion of Pt III, Div. 6AAA ITAA 1936, which is aimed at minimising the practice of transferring funds to non-resident trusts set up in low or no tax jurisdictions. These rules apply so that the income generated from those funds is taxable in Australia.
- Insertion of Sch 2F ITAA 1936 in 1999, which is aimed at minimising the practice of trafficking of trust losses. These provisions set out a range of tests which must be satisfied before a trust can deduct current and prior year losses and debt deductions. Essentially, these measures are aimed at ensuring the beneficial owners of the trust are the same in the current year as what they were when the losses were incurred.
- Insertion of Pt III, Div. 6D ITAA 1936 in 1999, which provides that all or part of the net income of the trust must pass to ultimate beneficiaries or result in tax being imposed at the highest marginal rate of tax plus the Medicare levy. Prior to these provisions being inserted into the law the income of the trust could be passed through a series of trusts with no ultimate beneficiaries being taxed on that income.

[145] If a resettlement occurs the original trust is treated as having disposed of the assets to the new trust at market value. If the assets in the trust have appreciated in value over time, there could be significant capital gains tax liabilities.

[146] If a resettlement occurs, there is considered to be a disposal of depreciating assets and trading stock to the new trust. This can result in the bringing forward of income tax liability but with no revenue generated at the time of the resettlement from the sale of those assets. For example, the trading stock is taken to have been sold at market value to the new trust before any revenue is generated from the sale of the trading stock in the business. Further, the trading stock may not actually be sold at the market value at resettlement at a later date.

- Insertion of Pt 2-42 ITAA 1997 in 2000, which was aimed at preventing individuals receiving the income they were generating from their personal services in a trust rather than receiving that income personally in order to benefit from an overall reduced tax liability through being able to income split their income within a family group. These individuals were claiming deductions beyond what they would be able to claim if they were providing the same services as an employee.
- Revised social security means test treatment of private trusts and private companies from 2002, who are broadly now treated as owning asset held in trusts as if they were holding them personally for the purposes of working out Centrelink entitlements under the means test.

5.14 Education

The insights gained from advisers at the roundtables suggest that there are several important stakeholder groups (outlined below) which have a poor understanding about the nature of family trusts and how they operate. This is seen as a concern as it undermines the use and effectiveness of businesses operated through family trusts.

Business owners

Some advisers highlighted that many of their clients do not really understand the key features of family trusts compared to other legal structures. One adviser noted that a client may be unsure about the difference between a corporate trustee and company 'in its own right'. It was suggested that some clients do not realise that they no longer have 'legal' ownership over the assets placed in a family trust. Concerns were expressed as to how the advisers' clients will react once they become fully aware of this. One adviser highlighted that this misunderstanding often comes to a head when a will is being drafted for a family member who has the misconception that trust assets form part of their estate. Such misconceptions have the potential to cause significant conflict and legal disputes between family members, such as when a family member's planned or actual use of trust assets is inconsistent with the trust deed.

Lending institutions

As highlighted earlier in 5.3, concerns were expressed with respect to using a family trust when seeking debt finance; the roundtable advisers considered companies to be given preferential treatment by the banks. It was the consensus that employees of banks are not entirely aware of how a trust works, and that this lack of understanding is further complicated by the fact that there is no 'standard' trust deed. Although this may create greater difficulty in family trusts acquiring necessary debt finance, advisers were of the view that the main concern for banks was in demonstrating the underlying security is sufficient.

Accounting profession

Concerns were expressed as to the level of knowledge of some practitioners in the accounting profession, particularly sole practitioners. Examples were given of how trusts were used inappropriately, such as placing the family home in a family trust where the risk exposure to the family did not warrant such an arrangement. This suggests that some business families are being poorly advised with respect to trusts, and are adopting legal structures incurring additional costs with little to no benefit. At one of the roundtable sessions, several advisers emphasised that when they acquire new clients, they are also inheriting the structures put in place for that client by their previous adviser. Numerous examples were given where Div. 7A issues were identified due to UPE, which their new clients were not aware of. This may have been a consequence of the clients' previous advisers not being aware of the Div. 7A issues faced by their client, or the difficulty of the client in understanding the structure put in place and the consequences of this.

General public

One of the major issues identified at the roundtables with respect to the environment in which trusts operate is that there is a lack of interest and understanding on the part of the general public. There is the general misconception that family trusts represent a 'tax avoidance' scheme, a view which has been further propagated during the recent federal election. This creates problems such as unfairly tainting those business families that use them legitimately and appropriately. It also stymies genuine and productive discussion at the federal level of how the law as applied to trusts can be reformed for the betterment of all.

6. Recommendations

On the basis of the foregoing, the following recommendations with respect to legal and regulatory reform in the space of family trust are made:

Recommendation 1 – Income Splitting

With respect to the taxation of income, investigate whether a 'single entity tax' which would apply uniformly to all business structures including companies, trusts, partnerships and sole proprietors would result in a simpler and more equitable tax system. Alternatively, investigate whether the 'individual' income tax unit should remain in Australia, or whether the tax unit should instead be the family unit. Adopting the family income tax unit would allow income averaging between families. Under this model, families that earn their income from salaries and wages will then be taxed in a similar manner to families that currently hold assets or are carrying on a business in a trust. The study can draw upon the income tax systems of jurisdictions outside of Australia that use the family as the income tax unit.

Recommendation 2 – Income Streaming

Prior to the introduction of the *Tax Laws Amendment (2011 Measures No 5) Act* 2011, there was considerable uncertainty as to whether a trustee of a trust was able to stream income with special characteristics such as capital gains and franked dividends. The position is now clear. The ability to stream income places trusts in an advantaged income tax position relative to other business structures. It is recommended that a 'single entity tax' be investigated which would apply uniformly for the taxation of all companies, trusts, and partnerships and sole proprietors.

Recommendation 3 – 50% CGT Discount in Division 115 of the ITAA 1997

The 50% CGT discount in Division 115 of the 1997 Act is available to individuals and trusts but not to companies. Provided the eligibility criteria are met, at the time of the disposal of assets, beneficiaries of a trust will be able to reduce their tax liability by half, however companies will miss out. This is resulting in complex business structuring involving the combination of both companies and trusts in order for the business to be able to access the 50% CGT discount on the disposal of assets. It is recommended that a 'single entity tax' be investigated which would apply uniformly for the income tax (including CGT treatment) of all companies, trusts, and partnerships and sole proprietors.

Recommendation 4 – Small Business CGT Concessions in Sub-div 152 of the ITAA 1997

Whilst the policy behind the Small Business CGT Concessions in Subdivision 152 of the ITAA 1997 is sound, the complexity of the provisions is overwhelming, even for the most experienced adviser. It is recommended that the Small Business CGT Concessions in Subdivision 152 of the ITAA 1997 be simplified. Given that any amendments to the Small Business CGT Concessions will have greatest impact on small business and family enterprise, to avoid any unintended consequences, it is recommended that the small business and family enterprise sector is consulted prior to any draft Bill being released.

Recommendation 5 – Division 6 of the ITAA 1936

The current operation of the rules in Division 6 is unclear, uncertain and in many cases unworkable. There is a clear case for the need to review and re-write Division 6 so that the manner in which the Division operates is clear and does not impose additional compliance burden on small business and family enterprise. Given that any changes will have greatest impact on small business and family enterprise, to avoid any unintended consequences, it is recommended that the small business and family enterprise sector is consulted prior to any draft Bills being released.

Recommendation 6 – Division 7A of the ITAA 1936

In order to support businesses whilst still maintaining the integrity of Australia's tax system, it is recommend that Div. 7A be amended so that the rules do not apply to private business loans where the borrowing entities are entitled to claim an income tax deduction for servicing such debt – an 'otherwise deductible rule'. This amendment will mean that if the Family Trust uses UPEs for business purposes, then provided that loan is on commercial terms, Div. 7A will not apply. This will more closely align the tax treatment of retained earnings in a corporate structure with that of a trading trust structure. Given that any amendments to Div. 7A will have greatest impact on small business and family enterprise, to avoid any unintended consequences, it is recommended that the small business and family enterprise sector is consulted prior to any draft Bills being released.

Recommendation 7 – The Rule against Perpetuities

It is recommended that the rule against perpetuities be abolished in each Australian jurisdiction, or alternatively, limit its operation so that commercial arrangements are not included within its scope. Given that South Australia has already abolished this rule, jurisdictions outside of South Australia can look to South Australia to determine the effect that the abolition of this rule has had on trading trusts in South Australia. At the very least, if there is no appetite to abolish or amend the rule in these jurisdictions, there needs to be some education around how the rule works and the likely financial impact on the trading trust at the vesting date. This will give the owners of the business the opportunity to seek professional advice so that they can avoid the operation of the rule.

Recommendation 8 – R&D Tax-offset under Division 355 of the ITAA 1997

A business carried on through a trust that is engaged in R&D is not eligible to receive the tax offset for its R&D activities. In order to access the concessions, the business must restructure into a corporate entity, which can result in tax liabilities as well as costs of restructuring. It is recommended that all entities, irrespective of their business structure are eligible for the R&D tax offset provided that they meet all other eligibility requirements under Division 355 of the ITAA 1997 for the tax offset.

Recommendation 9 – Trust Resettlements

Trust deeds are often amended and many of these amendments can result in the resettlement of the trust creating an unintended but significant taxing point for the business which could lead to an erosion of the businesses' asset base, or create considerable cash flow issues for the business, ultimately impacting on the ongoing viability of the business. It is recommended that small business and family enterprise and their advisers be consulted to determine in which situations trust deed amendments are required to either modernise the trust deed or to accommodate the various stages of the life cycle of a business. The law should be amended to allow for these variations to the trust deed of the trust without creating any taxing point. Such a measure will need to ensure that the integrity of the tax system is not undermined.

Recommendation 10 – Education to Improve Legal Literacy of Family Trusts

Educational initiatives be developed to increase the legal literacy regarding the nature and operation of family trusts to key stakeholder groups. This may include working with accounting bodies to ensure public accountants have the ongoing professional development to ensure they have the knowledge and skills to effectively advise their clients on the structuring and use of family trusts.

Recommendation 11 – Develop a 'Standard Trust Deed' Template

The availability of a 'standard trust deed' template for use by family and small businesses, which can be customised for their particular needs, would deliver multiple benefits. First, it would promote consistency by classing the most common features of family trust deeds as 'boilerplate' and encouraging their treatment as such. Second, it would provide a basis upon which family and small businesses could construct their own trusts. Third, in serving to avoid protracted drafting, it will be both economically and practically efficient.

The notion of developing a 'standard trust deed' template in no way seeks to downplay the critical importance of seeking appropriate professional legal and financial advice when preparing and drafting a trust deed. The commercial reality is that there is no 'one size fits all' instrument, as family and small businesses will each have their own needs which must be reflected in the deed. However, the use of a standard template as a starting point is likely to deliver the many benefits described above. It is recommended that a standard trust deed be developed and made available for commercial parties.

APPENDIX 1

Sample Family Trust Deed

BETWEEN

Settlor

AND

The Trustee

FAMILY TRUST DEED

THIS DISCRETIONARY TRUST DEED is made the day of 2019

BETWEEN:

("the Settlor")

AND

("the Trustee")

RECITALS:

A. The Settlor has expressed desire to transfer the sum of **$10.00** to the Trustee to be held and applied on the trusts and subject to the powers in this Deed.

B. The Trustee has agreed to hold and apply:

i. the promise of the Settlor to pay the sum of **$10.00** ("Settlement Sum"); and

ii. (upon payment) the Settlement Sum

on the trusts and powers hereafter described.

Definitions

1. In this Deed unless the context otherwise requires:

1.1. **Accounting Period** means:

1.1.1. each period of twelve months, ending on the 30th of June each year; the period starting on the date of this Deed, and ending on the 30th of the following June; and the period starting on the first day of July prior to the Vesting Day and ending on the Vesting Day; or

1.1.2. the other date as determined by the trustee by resolution from time to time;

1.2. **Appointor** in respect of the whole of the Trust Fund means [Appointors Name], and may also include any Person who takes the office of Appointor in relation to the whole or any Part of the Trust Fund pursuant to Clause 19;

1.3. **Associated Entities** means:

1.1.1. (if the Primary Beneficiary is a trust estate or settlement) - any Person who is:

1.1.1.1. a beneficiary contingently entitled to any Property of that trust estate or settlement (in this sub-clause referred to as "the Subject Property");

1.1.1.2. a beneficiary vested in possession of the Subject Property where the beneficial enjoyment thereof is either indefeasibly vested or is vested subject to a power of defeasance or divestiture (not capable of being exercised after the Vesting Day) granted or conferred on that trustee or another Person;

1.1.1.3. an object or potential object of any special or hybrid or other power of appointment (but not including any general power of appointment) granted or conferred on that trustee or another Person in relation to the Subject Property;

1.1.1.4. an object of any power of selection granted or conferred on the trustee of any trust or settlement for distribution of the Subject Property; and

1.1.1.5. an object of any mere power or collateral power granted or conferred on any Person in relation to the Subject Property;

1.3.1. the Trustee (in its capacity as trustee) of any Sub-Trust for the Primary Beneficiary or any Specified Relative thereof;

1.3.2. the executors or administrators or other legal personal representatives of a deceased Primary Beneficiary and the widow widower and Specified Relatives of the deceased Primary Beneficiary or any of them entitled thereto under or by virtue of the will of the deceased Primary Beneficiary or under or by virtue of the rules relating to intestacy as one of the next-of-kin of that Primary Beneficiary;

1.3.3. any Company in which the Primary Beneficiary or any Specified Relative thereof is a director shareholder or officer;

1.3.4. any Company of which a Company referred to in Sub-clause 1.3.3 is a related corporation within the meaning of that expression in Section 50 of the *Corporations Act 2001* (Cth);

1.3.5. any Person who is:

1.3.5.1. a director;

1.3.5.2. an officer; or

1.3.5.3. a shareholder

of any Company referred to in Sub-clauses 1.3.3 or 1.3.4;

1.3.6. any Sub-Trust for:

1.3.6.1. any of the Companies or other Persons referred to in Sub-clauses 1.3.3, 1.3.4 or 1.3.5; or

1.3.6.2. any Sub-Trust referred to in Sub-clause 1.1.1

or any one or more of them;

1.3.7. any Company or other Person who is:

1.3.7.1. a beneficiary contingently entitled to Property;

1.3.7.2. a beneficiary vested in possession of Property where the beneficial enjoyment thereof is either indefeasibly vested or is vested subject to a power of defeasance or divestiture (not capable of being exercised after the Vesting Day) granted or conferred on that trustee or another Person;

1.3.7.3. an object or potential object of any special or hybrid or other power of appointment (but not including any general power of appointment) granted or conferred on that trustee or another Person in relation to Property;

1.3.7.4. an object of any power of selection granted or conferred on the trustee of any trust or settlement for distribution of Property; and

1.3.7.5. an object of any mere power or collateral power granted or conferred on any Person in relation to Property

impressed with the trusts expressed or implied in any Sub-Trust referred to in Sub-clause 1.3.6;

1.3.8. any Person who is an associate of the Primary Beneficiary or Specified Relative thereof within the meaning that expression in Section 318 of the *Assessment Act 1936* or would be an associate as so defined as if a reference to a "taxpayer" in that definition were a reference to the Primary Beneficiary or Specified Relative thereof respectively; or

1.3.9. any charitable institution or Person howsoever constituted which the Trustee in his or her absolute discretion considers worthy of receipt of funds either for charitable or educational purposes or for the relief of poverty or religious scientific or public educational purposes in Australia including a public hospital or any hospital which is carried on by a society or association otherwise than for profit or gain to the individual members thereof or any of them;

1.4. **Assessment Act 1936** means the *Income Tax Assessment Act 1936* (Cth);

1.5. **Assessment Act 1997** means the *Income Tax Assessment Act 1997* (Cth);

1.6. **Beneficiary** in relation to each Part means:

1.6.1. the Primary Beneficiary of that Part;

1.6.2. the Specified Relatives of the Primary Beneficiary of that Part; and

1.6.3. the Associated Entities of the Primary Beneficiary of that Part;

despite any other aspect of this clause regarding property which has become part of the Trust Fund and transferred to the Trustee in accordance with section 71CC of the *Stamp Duties Act 1923* (SA) only those persons specified in this clause who are a relative of the natural person who transferred the property or whose Trustee transferred the property to the Trustee and which has become part of the Trust Fund;

1.7. **Commencement Date** means the date first written in this Deed;

1.8. **Distributor** in respect of the whole of the Trust Fund means:

1.8.1. at the Commencement Date: no-one;

1.8.2. thereafter: the person (if any) from time to time appointed by the Trustee in relation to the whole or any Part of the Trust Fund; and

1.8.3. any Person who takes the office of Distributor pursuant to Clause 19;

1.9. **Disqualification Event** means both of the following:

1.9.1. (in relation to a natural person) someone:

1.9.1.1. who:

1.9.1.1.1. benefits;

1.9.1.1.2. may benefit from;

1.9.1.1.3. is an Officeholder; or

1.9.1.1.4. operates any aspect of this Trust; and

1.9.1.2. who:

1.9.1.2.1. becomes bankrupt;

1.9.1.2.2. is of unsound mind;

1.9.1.2.3. is incapacitated;

1.9.1.2.4. does anything that would disqualify a Trustee from being a Director of a company;

1.9.1.2.5. is in the opinion of the Trustee likely to become divorced;

1.9.1.2.6. has threatened or actual proceedings under any law made against a beneficiary by a spouse or former spouse for maintenance or support or property settlement;

1.9.1.2.7. is in the opinion of the Trustee likely to become insolvent; or

1.9.1.2.8. commits an act of bankruptcy as defined by section 40 of the *Bankruptcy Act 1966* (Cth); and

1.9.2. (in relation to a body corporate) a Company:

1.9.2.1. who:

1.9.2.1.1. benefits;

1.9.2.1.2. may benefit from;

1.9.2.1.3. is an Officeholder; or

1.9.2.1.4. operates any aspect of this Trust; and

1.9.2.2. who:

1.9.2.2.1. goes into liquidation;

1.9.2.2.2. goes into receivership;

1.9.2.2.3. goes into administration; or

1.9.2.2.4. commits an act of bankruptcy as defined by section 40 of the *Bankruptcy Act 1966* (Cth);

1.10. **Excluded Beneficiary** means:

1.10.1. the Settlor;

1.10.2. any Person to whom a Disqualification Event has happened, until the time (if any) that the Trustee is satisfied that the Disqualification Event has ended;

1.10.3. any Person whom the Trustee with the consent of the Guardian (if any) of the whole or any Part of the Trust Fund has determined to be absolutely partially conditionally or unconditionally excluded from the class Beneficiaries of the whole or any Part of the Trust Fund;

1.10.4. where the Trust or any Part of the Trust:

1.10.4.1. owns Australian real property or is has entered a contract to purchase Australian real property; and

1.10.4.2. the Australian real property owned or to be purchased is located in a jurisdiction that would impose higher rates of stamp duty, land tax or other tax on the Trust or that Part if one or more Beneficiaries are not residents of Australia; then

1.10.4.3. any Person who is not ordinarily a resident of Australia is excluded as Beneficiary in relation to the Trust or that Part of the Trust; and

1.10.5. in the case of a Person:

1.10.5.1. excluded partially - to the extent of the exclusion; and

1.10.5.2. excluded conditionally - for the duration of the:

1.10.5.2.1. period of time;

1.10.5.2.2. existence of the circumstances; or

1.10.5.2.3. other condition

of the exclusion of that Person

subject to the power of the Trustees to amend or revoke any such determination or notice at any time;

1.11. **Guardian** in respect of the whole of the Trust Fund means:

1.11.1. at the Commencement Date: no-one;

1.11.2. thereafter: the person (if any) from time to time appointed by the Trustee in relation to the whole or any Part of the Trust Fund; and

1.11.3. any Person who takes the office of Guardian pursuant to Clause 19;

1.12. **Jurisdiction** means South Australia;

1.13. **Minor** means a person who is under eighteen years of age;

1.14. **Net Income** means net profit of the Trust to the extent not already included, the gross income, minus all losses and expenses and all accretions to the capital of the Trust Fund. Net Income is determined in accordance with:

1.14.1. (subject to Clause 1.14.2) Section 95(1) of the *Assessment Act 1936* including (but without limiting the generality of the foregoing) all corpus and accretions thereto that are required to be included in the assessable income of the Trust pursuant to the provisions of Sub-section 102-5(1) of the *Assessment Act 1997*;

1.14.2. if the Trustee so directs - the accounting methods or procedures from time to time determined by the Trustee to be the methods or procedures by which:

1.14.2.1. the Division 6E Income and Division 6E Net Income (as each is defined in Sub-section 102(UY) of the *Assessment Act 1936*) is ascertained;

1.14.2.2. the Capital Gains or Net Capital Gains are calculated under and pursuant to Sub-sections 115-215(3) and 115-225 to 115-228 of the *Assessment Act 1936*; and

1.14.2.3. Streamed Dividends or the aggregate of Specifically Entitled Amounts thereof (within the meaning of Section 207-58) are ascertained

for an Accounting Period; and

1.14.3. (subject to Clauses 1.14.2.1 and 1.14.2) generally accepted accounting methods and standards

AND a reference to income is to be construed accordingly **AND** (in relation to a Distribution of Net Income) the expression has the additional meaning it would have as if a reference to a Distribution of Net Income were a reference to a Distribution of Property constituting or representing Net Income;

1.15. **Officeholder** means each of, and each one of:

1.15.1. the Trustee;

1.15.2. the Appointor;

1.15.3. the Distributor; and

1.15.4. the Guardian

in respect of the whole or a specific Part of the Trust Fund, as the context requires

AND Office means those respective offices;

1.16. **Part** means at the date hereof the whole of the Net Income and corpus of the Trust Fund **AND** thereafter the Parts as segregated and divided from time to time (in accordance with Clause 20);

1.17. **Person** includes:

1.17.1. a natural person;

1.17.2. a partnership or a firm;

1.17.3. a company or any other entity whether formed or recognised within the Jurisdiction or otherwise;

1.17.4. any of the foregoing acting in the capacity as trustee of any trust estate or settlement; and

1.17.5. the legal personal representatives, executors, administrators, agents, assigns and successors of any of the foregoing;

1.18. **Primary Beneficiary** means:

1.18.1. (for their life) **[Name of Primary Beneficiary]**;

1.18.2. (upon the death of the last of the Persons in 1.18.1) in relation to each Part, the first Officeholder extant for that Part in the below list:

1.18.2.1. the Appointor; then;

1.18.2.2. the Distributor; then

1.18.2.3. the Guardian; then

1.18.2.4. the Trustee;

1.19. **Public Trustee** means the Public Trustee in the Jurisdiction;

1.20. **Settlor** means **[Name of Settlor]**;

1.21. **Spouse** means in relation to a person:

1.21.1. their husband or wife;

1.21.2. any person who the Trustee believes is their husband or wife in fact;

1.21.3. their domestic partner (within the meaning of the *Family Relationships Act 1975* (SA));

1.21.4. their widow or widower, even if remarried;

1.21.5. any person who the Trustee says, after the death of that person, was a wife in fact or husband in fact of that person during that person's life

BUT Spouse does not include a former husband or wife or a former domestic partner;

1.22. **Specified Relatives** in relation to a person means all of following:

1.22.1. their Spouse;

1.22.2. their lineal descendant;

1.22.3. the Spouse of any of their lineal descendants;

1.22.4. their parents, grandparents, brothers, sisters, cousins, nephews or nieces; and

1.22.5. the Spouse of any of their parents, grandparents, brothers, sisters, cousins, nephews or nieces;

1.23. **Sub-Trust** means in relation to a Person thereof means the trustee (in its capacity as trustee) for the time being or from time to time of any trust estate or settlement which holds or is possessed of any property or any part thereof or any interest therein (in this Sub-clause referred to as "Property") where the Person (as the case may be) is at any relevant time:

1.23.1. a beneficiary contingently entitled to the Property;

1.23.2. a beneficiary vested in possession of the Property where the beneficial enjoyment thereof is either indefeasibly vested or is vested subject to a power of defeasance granted or conferred on the trustee or another Person;

1.23.3. an object of any special or hybrid or other power of appointment (but not including any general power of appointment) granted or conferred on the trustee or another Person in relation to the Property;

1.23.4. an object of any power of selection granted or conferred on the trustee of any trust for distribution of the Property; and

1.23.5. an object of any mere power or collateral power granted or conferred on any Person in relation to the Property

BUT the expression does not include any trust estate or settlement in which any Person is capable of being vested in an interest in the Property after the Vesting Day;

1.24. **Trustee** means:

1.24.1. the Person named in this Deed as the Trustee; and

1.24.2. a Trustee appointed under the terms of this Deed (including in accordance with Clauses 19;

1.24.3. a Person who is acting as a custodian trustee;

1.25. **Takers in Default** means in relation to the whole or any Part of the Trust Fund the Primary Beneficiaries of the whole or that Part of the Trust Fund;

1.26. **Trust Fund** means:

1.26.1. the Settlement Sum;

1.26.2. all monies, investments and property paid or transferred to and accepted by the Trustee as additions to the Trust Fund;

1.26.3. accumulations of income as specified in this Deed; and

1.26.4. all accumulations to the Trust Fund;

AND a reference to the Trust Fund may refer to a particular Part of it, as the context requires;

1.27. **Vesting Day** means:

1.27.1. the last to occur of:

1.27.1.1. the eightieth anniversary of the Commencement Date;

1.27.1.2. the day that is 21 years after the death of the last lineal descendant of Her Majesty Queen Elizabeth II living as at the Commencement Date; and

1.27.1.3. (if the Trust Fund is not subject to the rule against perpetuities and can vest on a day outside the period referred to in clauses 1.27.1.1 and 1.27.1.2) the day outside the period referred to in clauses 1.27.1.1 and 1.27.1.2 that the Trustee says in a deed is the Vesting Day; or

1.27.2. the day the Trustee says in a deed is the Vesting Day, being a day earlier than those referred to in clause 1.27.1;

Interpretation:

1.28. In the interpretation of this Deed:

1.28.1. The Recitals are true and correct in every material particular and shall form part of this Deed but any fact or matter referred to in those Recitals that is inconsistent with any term or provision thereafter appearing shall be read as subject to that term or provision;

1.28.2. Every aspect of this document with the exception of the headings are substantive parts of this Deed and are to be read accordingly;

1.28.3. Headings are used in this Deed for convenience, but are not to be interpreted as part of this Deed;

1.28.4. When the singular is mentioned, it also means the plural of that word, and vice versa;

1.28.5. Words specifying one gender includes all other genders;

1.28.6. When legislation is referred to, the legislation includes all rules, ordinances, by laws, orders, regulations, consolidations, rewrites, amendments, re-enactments and replacements of that same legislation;

1.28.7. When the word 'writing' is mentioned, this means, in addition to its plain language meaning, email, facsimile, instant message and other forms of electronic transmission;

1.28.8. When, under this Trust Deed, one Person is required to give written notification, it is to be given by one of the following:

1.28.8.1. delivered in Person; or

1.28.8.2. posted to the other Persons' address, which is taken to have been received three business days after it was posted; or

1.28.8.3. sent by email to their email address, which is taken to have been received when it is delivered to the server; or

1.28.8.4. using another form of electronic communication agreed in writing between that Person and the Trustee to be acceptable, which is taken to have been received when the communication is delivered to the server.

Declaration of Trust

2. The Settlor promises to pay the sum of **$10** to the Trustee and the Trustee hereby declares that with effect from the Commencement Date, the Trustee will stand possessed of the Trust Fund upon the trusts and with and subject to the powers and provisions set out in this Deed.

Name of Trust

3. This Trust is to be known as the **FAMILY TRUST.**

Distributions of Net Income

4. (Subject to the Guardians' and Distributors' powers as set out in Clause 5 and 6 respectively) In relation to distributions of Net Income:

Discretions

4.1. The Trustee has the power and discretion to:

4.1.1. distribute the Net Income to the Beneficiaries at the end of each Accounting Period;

4.1.2. pay, apply, accumulate or set aside Net Income before the end of the Accounting Period to Beneficiaries;

4.1.3. decide what classifies as Net Income of the Trust Fund;

Default Distribution

4.2. If the Trustee does not make a determination regarding the whole or part of the Net Income before the end of the Accounting Period, it is to be distributed to the Takers in Default;

Guardians and Distributors

4.3. Guardians' and Distributors' powers (as set out in Clause 5 and 6 respectively) applies only to distributions of Net Income and corpus made at the discretion of the Trustee and does not apply in relation to non-discretionary distributions, including the vesting of this trust upon the Vesting Date;

Excessive Accumulations

4.4. (if the rule against excessive accumulations applies to all or a part of the Trust Fund) Net Income may not be accumulated beyond the period allowed by that rule in relation to the part of the Trust Fund subject to that rule;

Streaming

4.5. The Trustee may exercise discretion to pay or allocate to a Beneficiary income from any:

4.5.1. class;

4.5.2. source; or

4.5.3. category

of income; or

4.6. Classes sources and categories of income may include:

4.6.1. interest;

4.6.2. rental income;

4.6.3. fully or partially franked dividends;

4.6.4. unfranked dividends;

4.6.5. capital gains;

4.6.6. trading income;

4.6.7. foreign source;

4.6.8. where a foreign tax or other credit applies; and

4.6.9. exempt from tax.

Guardian Consent for Proposed Distributions

5. If there is a Guardian appointed in relation to the whole or any Part of the Trust then:

Distribution Notice to Guardian

5.1. the Trustee must before distributing any Net Income (including accumulations and in specie distributions) in relation to the whole or the Part of the Trust in which that Guardian is appointed give that Guardian not less than 2 days written notice ("Distribution Notice") of any proposed distribution specifying:

5.1.1. the date and time on which the proposed Distribution is to be made;

5.1.2. the names of the Beneficiaries selected by the Trustee to benefit in exercise of the Trustee's discretion; and

5.1.3. the amounts or values of the proposed distribution to be distributed to each of those Beneficiaries;

Guardian May Object

5.2. after receipt of the Distribution Notice the Guardian may by written notice received by the Trustee not later than the date and time of the proposed Distribution advise the Trustee that the Guardian:

5.2.1. objects to the whole of the proposed Distribution; or

5.2.2. objects to part only of the proposed Distribution;

Consequences of Guardian Action

5.3. if the Guardian:

5.3.1. gives the notice referred to in clause 5.2.1, the Trustee must not distribute pursuant to the Distribution Notice;

5.3.2. gives the notice referred to in clause 5.2.2, the Trustee shall not distribute so much of the proposed Distribution as the Guardian has objected to but the Trustee may proceed to distribute the balance of the Distribution to which the Guardian has not objected; and

5.3.3. has consented to the Distribution Notice or where no objection has been received by the Trustee before the time for making the proposed distribution, the Guardian shall be deemed to have consented to the whole of the proposed Distribution referred to in the Distribution Notice;

Distributor vs Guardian

5.4. a notice given by a Distributor to the Trustee in accordance with Clause 6 voids the requirement under this Clause for the Trustee to seek the consent of the Guardian in relation to that Part for that distribution;

Consequences of Failure to Comply

5.5. a failure by the Trustee to comply with the requirements of this Clause causes the proposed distribution to fail and instead be held on trust absolutely for the Primary Beneficiary of that Part; and

No Guardian

5.6. if there is no Guardian at the time the Trustee determines to make a proposed distribution the Trustee may make the distribution without seeking consent in accordance with Clause 5.1.

<u>Distributor</u>

6. Where the Distributor of a Part notifies in writing the Trustee ("Distribution Notice") of the Beneficiaries who are to receive a distribution in relation to the Net Income or corpus of that Part:

6.1. The Distribution Notice has effect as if they were resolutions made by the Trustee.

6.2. The Trustee is not permitted to act inconsistently with the Distribution Notice.

<u>Vesting of Trust Fund:</u>

7. In relation to the vesting of the Trust:

7.1. the Trust Fund vests on the Vesting Day among the Takers in Default. Until then, the Trustee has the power to exercise their discretion to distribute Net Income and corpus as the Trustee sees fit;

7.2. (if there is no Person who satisfies Sub-Clause 7.1 on Vesting Day) then the Trustee holds the Trust Fund for any Person who under the Taker in Default's Will is entitled to the Trust Fund;

7.3. (if there is no Person who satisfies Sub-Clause 7.1 or 7.2 on Vesting Day) then the Trustee holds the Trust Fund for the Beneficiaries living at the Vesting Date equally;

7.4. (if there is no Person who satisfies Sub-Clause 7.1, 7.2 or 7.3 on Vesting Day) then the Trustee holds the Trust Fund for charitable purposes as the Trustee determines; and

7.5. if either of these events in Sub-clauses 7.1, 7.2, 7.3 or 7.4 occur, any resulting trust to the Settlor is cancelled.

Appointment of Additional Beneficiaries:

8. The Trustee with the consent of the Guardian may by resolution in writing nominate additional Beneficiaries who may benefit from this Trust Fund. The following restrictions apply:

   8.1. a Person acting in their capacity as a trustee of another trust may only be appointed as a potential Beneficiary in their capacity as Trustee if that further trust is required to vest before the Vesting Day; and

   8.2. doing so would not breach the fiduciary obligations of the Trust.

ADMINISTRATION OF THE TRUST FUND

Exercise of Discretionary Power by Trustee

9. The Trustee has the power under this Deed to exercise power in the following ways:

   9.1. The Trustee has the power exercise their discretion at any time;

   9.2. The Trustee is required to keep proper records of decisions;

   9.3. It is a requirement that all records be kept to record:

      9.3.1. minutes of all resolutions and proceedings; and

      9.3.2. records of all the Trustees' dealings, including records and receipts of expenditure.

Determinations by Trustee

10. A determination made by the Trustee is at the absolute discretion of the Trustee. This determination is to be made in writing if it concerns real property. The Trustee has the power to make valid oral declarations according to law if the declaration concerns other assets in the Trust Fund. The Trustee does not have to provide a reason for their decision.

Assistance of Professionals

11. The Trustee has the power to:

   11.1. employ a legal practitioner to provide a written opinion regarding the interpretation of this Trust Deed or other related documents; and

   11.2. employ a professional advisor to provide an opinion regarding the administration of the Trust Fund;

12. The Trustee is not liable for any omission or act done in accordance with either the advice of a legal practitioner or professional advisor.

No Obligation to Act Personally

13. The Trustee:

   13.1. is not bound to act personally when dealing with the Trust Fund;

   13.2. may act in any capacity, professional or otherwise, to administer the Trust and may decide on remuneration accordingly;

   13.3. may become a director of a company that forms part of the Trust Fund, provided that:

13.3.1. the Trustee has notified all Officeholders of the Trustees' interest; and

13.3.2. accounts to the Trust Fund for all dividends and bonuses the Trustee has incurred.

Charge for Services

14. The Trustee may charge a fee for the services they provide. The Trustee may charge the same amount that the Public Trustee in the relevant Jurisdiction charges for the same services. The remuneration (if any) may be paid out of the Net Income of the Trust Fund, at the Trustees discretion.

Professional Fees

15. If the Trustee is engaged in a profession, they are entitled to be paid at their ordinary commercial rate for their professional work regarding the Trust Fund.

Expenses of the Trust Fund

16. The Trustee has the discretion to pay all expenses and costs of administering the Trust Fund out of the Net Income of the Trust.

Trustee Indemnity

17. The Trustee:

17.1. is not personally liable or liable in their capacity as Trustee for any genuine acts or omissions that are injurious to the Trust.

17.2. is entitled to be indemnified from the Trust assets for their actions, except where there is an:

17.2.1. intentional breach of trust;

17.2.2. bad faith;

17.2.3. fraud; or

17.2.4. gross negligence

BUT the Beneficiaries are not personally obliged to provide indemnity to the Trustee.

Variation of Trust Deed

18. The Trustee with the consent of the Appointor (if any) in relation to that Part of the Trust has the power to, by a Deed of Variation, vary, revoke or amend any part of this Deed **PROVIDED THAT** such variation shall not:

18.1. (if the rule against perpetuities applies to the whole or any Part of the Trust Fund) conflict with the rule against perpetuities for the whole or that Part of the Trust Fund that the rule against perpetuities applies to;

18.2. result in a benefit to the Settlor; or

18.3. affect the entitlements of any Beneficiary who is currently able to benefit from the Trust Fund in any way.

<u>Appointment, Removal and Retirement of Officeholders</u>

19. In respect of each Office and in relation to the whole and each Part of the Trust Fund:

    19.1. an Officeholder may, by written notice to the Trustee:

        19.1.1. retire from their Office;

        19.1.2. nominate a replacement for their Office

    and this shall take effect upon receipt of the notice by the Trustee, or at the later time (if any) specified in that notice;

    19.2. an Officeholder may retire or nominate a replacement for the whole or any Part of the Trust Fund for which they are appointed, including in relation to a Part segregated in accordance with Sub-clause 20.1;

    19.3. the Appointor (and if there is no Appointor, then the Trustee) in relation to the whole or a specific Part of the Trust Fund may by deed in relation to the Part of Trust for which they are an Officeholder:

        19.3.1. remove any Trustee;

        19.3.2. replace a Trustee; or

        19.3.3. appoint one or more additional Trustees;

    19.4. If a Trustee is removed in relation to the whole or any Part of the Trust Fund but as a result of this there would be no Trustee controlling some Part of the Trust Fund, the removal does not take effect until a new Trustee has been appointed;

    19.5. An Officeholder is terminated and removed from their Office if a Disqualification Event occurs to that Officeholder;

    19.6. An Officeholder's powers shall vest in any Person who is:

        19.6.1. the attorney of the Officeholder pursuant to an enduring power of attorney whilst the Officeholder lacks capacity to act; and

        19.6.2. the executor, administrator or legal personal representative of that Officeholder if that Officeholder is deceased.

Segregate and Split Trust

20. In addition to the powers contained in this Deed an Appointor over the whole or any Part of the Trust Fund may with the written consent of the Guardian for the whole or that Part of the Trust Fund (if there is one) by instrument in writing direct the Trustee (or Trustees) of the whole of the Trust Fund to do one or more of the following:

    20.1. segregate a portion of the assets and liabilities of the Trust Fund ("Segregated Part") equal in proportion to that Part (or one or more new Parts that are fractions of the Part to which the Appointor is appointed in respect of) and as to as far as is practicable:

        20.1.1. administer that Segregated Part on the same trusts constituted by this Deed but separately from the remaining assets and liabilities of the Trust Fund; **<u>AND</u>**

20.1.2. Net Income and corpus from this Segregated Part:

20.1.2.1. constitute the entirety of the Trust Fund available for the benefit of the Beneficiaries of that Segregated Part and control by the Officeholders of that Segregated Part; **AND**

20.1.2.2. are not available for the benefit of the Beneficiaries of the remainder of the Trust Fund or control by the Officeholders of the remainder of the Trust Fund;

20.2. appoint the specified new Trustee or Trustees over that Segregated Part; and

20.3. retire as Trustee over that Segregated Part

AND the assets and liabilities of the Segregated Part segregated under Sub-clause 20.1 are to be, to the greatest extent possible, proportionate in composition to the Trust Fund;

Wills Direction

21. If the will of the last surviving Appointor in relation to a Part contains a direction to the Trustee ("Wills Direction"), then the Trustee is required to duly and punctually:

21.1. distribute the capital of that Part of the Trust Fund to the Beneficiaries at the times and in the manner and in the amounts or in respect of the property specified in the Wills Direction; and

21.2. otherwise comply with any directions requests or wishes concerning:

21.2.1. the Net Income of that Part of the Trust Fund;

21.2.2. segregating the Trust Fund in accordance with Clause 20; or

21.2.3. the appointment of or replacement of the Officeholders over all or a specific Part of that Part;

21.2.4. the activities powers or discretions of the Trustee

AND a Wills Direction is deemed to form part of this Deed and is binding on the Officeholders.

Joint Acts

22. Where more than one Person is appointed as a Trustee, all decisions regarding the Trust Fund are to be made by a majority of all Trustees.

Application of Law

23. In addition to the rules specified in this Trust Deed, the *Trustee Act 1936* (SA) and any other Act applying to trustees in the Jurisdiction applies to the Trustees of this Trust Fund. This is true unless:

23.1. the legislation is modified (either expressly or impliedly) by this Deed; or

23.2. the legislation is inconsistent with the terms of this Deed.

Proper Law

24. The proper law for the site of any traditional Jurisdiction property is the place of that traditional Jurisdiction; and

24.1. the construction and interpretation of this Deed;

24.2. the site of the Trust Fund (other than any traditional Jurisdiction property)';

24.3. the enforcement of the Clauses in this Trust Deed; and

24.4. the determination of remedies against the Trustee

is the place of the Jurisdiction.

POWERS OF THE TRUSTEE

25. The Trustee has the power under this Deed to exercise power in the following ways:

Protect the Trust Fund

26. The Trustee may take actions it considers necessary to protect the Trust Fund.

Carry on Business

27. The Trustee has the power to carry on business on the Trust Fund anywhere in the world. The Trustee has the discretion to enter into transactions as if they were the absolute beneficial owner of the property in the Trust Fund.

28. The Trustee may deal with real or personal property of the Trust Fund in any manner allowed by law or equity, including to:

28.1. gain income or profit from the property;

28.2. protect the property;

28.3. increase the value of the property;

28.4. make the property saleable; or

28.5. to subdivide land or build on land.

Lend and Borrow Money

29. The Trustee may lend or borrow money from any Person even if the Trust Fund is already entirely invested.

30. The lender does not need to ask:

30.1. whether it is necessary for the Trustee to borrow money; or

30.2. what the money may be used for.

Give Security and guarantees

31. The Trustee may secure payment of money, or secure a guarantee by a:

31.1. mortgage;

31.2. bill of sale;

31.3. lien; or

31.4. charge

over the Trust Fund.

Give Guarantees

32. The Trustee may give a:

32.1. guarantee;

32.2. guarantee and indemnity; or

32.3. indemnity

for the payment of money or for the performance of any obligation.

Grant Options

33. The Trustee may grant options over any aspect of the Trust Fund.

Invest Money

34. The Trustee may invest money in any investments they think are appropriate.

Purchase Shares and Debentures

35. The Trustee may purchase any:

35.1. shares;

35.2. stocks;

35.3. bonds;

35.4. mortgages;

35.5. debentures;

35.6. obligations; or

35.7. securities

of any governmental authority or company.

Purchase Investments and Annuities

36. The Trustee may make or purchase any investments on behalf of the Trust Fund even if the investment is greater than the amount of the Trust Fund.

Vary Investments and Security

37. The Trustee has the power to vary any investments and security.

38. The validity of any security remains intact even if there was an error of law or fact by either the Trustee or the Trustees' advisors.

Open Bank Account and operate those Accounts

39. The Trustee has the power to:

39.1. open a financial account with any financial institution;

39.2. operate those accounts as the Trustees determines is necessary;

39.3. open a financial account in the Trustees' name if the Trust Fund has money in it; and

39.4. give security to financial institutions that have been incurred by the Trust Fund.

Appoint a Power of Attorney

40. The Trustee may in writing appoint a Power of Attorney to administer the affairs of the Trust Fund as the Trustee directs.

41. The Trustee is not legally responsible for the actions of the attorney.

Purchase Residence for Beneficiaries

42. The Trustee has the power to purchase a house or land or both of them for a Beneficiary and purchase land and build a house on it.

43. The Beneficiaries may occupy the residence until the Vesting Day.

Advancement and Investment

44. Prior to Vesting Day, the Trustee has the power to pay out or apply the capital of the Trust Fund in any Part for the benefit or any Beneficiary as the Trustee determines.

Minor Beneficiaries

45. If a Beneficiary of this Trust Fund is a Minor, the Trustee may choose, at their discretion, to pay that Beneficiaries entitlement to that Beneficiaries parent, guardian, or carer.

46. This money is to be used for the benefit of the Beneficiary.

Legally Incapable Beneficiaries

47. If a Beneficiary of this Trust Fund is legally incapable, the Trustee may choose, at their discretion, to pay that Beneficiaries entitlement to that Beneficiaries parent, guardian or carer. This money is to be used for the benefit of the Beneficiary.

Employ people

48. The Trustee may employ any Person to do any work required under this Trust Deed. The Trustee may:

48.1. decide on that Person's remuneration; and

48.2. decide the arrangements regarding superannuation.

PERPETUITY RULES

49. If the proper law of this Trust becomes the law of another jurisdiction that has the rule against perpetuities then the following apply:

49.1. the distribution date is the last day allowable under law;

49.2. variations of this Trust Deed are not permitted if it would impact on the rule against perpetuities; and

49.3. the Trustee is not able to make another distribution to other trusts if it impacts the rule against perpetuities.

50. If the Trustee acquires property on behalf of the Trust in a jurisdiction that is subject to the law against perpetuities it is the Trustees duty to ensure the property is disposed of or vested at a time where it does not conflict with the rule of perpetuities.

SIGNED as a Deed on the date first written

SIGNED by [Settlor]

....
In the presence of:

....
Name of Witness Witness Signature

SIGNED by **<u>Trustee</u>**

....
In the presence of:

....
Name of Witness Witness Signature

APPENDIX 2

Roundtable Consultation Questions

THE UNIVERSITY of ADELAIDE

Research into Family Trusts in Small Business and Family Enterprise

Consultation Questions

Choice of business structure

1. Which business structures are most commonly utilised by your clients? What do you see as the benefits of these business structures over the use of a family trust?

2. What are the common characteristics that you take into account when advising clients to structure their business in a family trust?

3. What are your clients most concerned about when choosing the right business structure for their business?

4. Is a family trust a good business structure for a small family business? Which other structures would work for a small family business?

5. Would you ever recommend the use of a family trust as a business structure for unrelated parties?

6. Are your family business clients driven by any non-economic considerations when deciding on their preferred business structure? In what ways does a family trust assist business families in achiving their non-economic objectives?

7. Do you think your clients have a good general knowledge as to how family trusts operate, and their rights and obligations under the relevant trust deed and/or at common law? Or do they rely solely on you as their trusted advisor?

8. Australian Bureau of Statistics data suggests businesses operated through a trust structure have a higher survival rate when compared to other business structures. Is this consistent with your experience and why?

Configuration and use of family trusts

9. In your practice, how common are businesses structured as partnerships of family trusts or other hybrid structures incorporating a family trust(s)?

10. How can family trusts be incorporated into other business structures? i.e. ownership of shares, SMSF and business real property etc.

11. In which situations would you advise your clients to restructure from a family trust into an alternative structure?

12. What are some of the commonly cited issues or difficulties experienced by your clients with respect to family trusts?

13. What is your general approach when advising clients who are structured in a family trust as to their succession plan?

14. Is it more difficult to execute a succession plan in a family trust structure when compared to other types of business structures?

15. Is a family trust structure problematic if a business is trying to raise capital (using debt, equity, and/or bringing in an outside investor such as a PE firm)? Are these issues easy to overcome?

16. How common are disputes concerning family trusts? Which parties to the trust are typically the ones to initiate the dispute?

Taxation issues surrounding use of family trusts

17. What are your main concerns with respect to the income tax consequences of a business that is being carried on in a family trust?

18. What are the difficulties in being able to access the CGT small business concessions in a family trust business structure?

19. What is the approach of the ATO and Revenue SA when dealing with family trusts as business structures versus other types of business structures?

20. What are your primary concerns with the operation of Division 7A and Unpaid Present Entitlements?

21. Do the trust vesting rules impact on many of your clients who are carrying on a business in a family trust? Can any adverse tax consequences resulting from the vesting of their family trust be easily avoided?

22. When would you advise your clients to make a Family Trust Election?

23. Are there any adverse tax or other consequences that may arise in a family trust structure versus other business structures upon the death of a principal of the business?

Concluding questions

24. Do you think the use of family trusts will grow or decline in the future? Why?

25. Are there any other issues we should be aware of with regard to operating a business through a family trust?

22 April 2019

Project Leaders Associate Professor Christopher Graves, Dr. Sylvia Villios and Dr. Mark Giancaspro acknowledge the assistance of the Australian Small Business and Family Enterprise Ombudsman in providing funding for this project.

APPENDIX 3

Minutes of Roundtable 1 (3 May 2019)

Family Trust Roundtable
Held at the University of Adelaide on 3 May 2019
MINUTES

The Family Trust Roundtable took place at the University of Adelaide on Friday, 3 May 2019. There were eight participants, four accountants and four lawyers all having many years' experience in advising small businesses and family enterprises. For simplicity, these participants have been referred to as 'advisers' in the Minutes.

Executive Summary

- The most common business structure involves a combination of different entities – including companies and family trusts. Most commonly, a company will be the trading entity for a business and a family trust will own the appreciating assets associated with that business. A family trust is also commonly used as the shareholder of the trading company.
- The consensus view was that minimisation of tax is the often the most important factor when determining the structuring of a family business, as well as: the ability to raise capital, limitation of liability, exit plan, succession planning, access to grants and concession and the ability to introduce new investors.
- The benefits of using a company are: the ability to use franking credits, a reduced tax rate, potentially less Division 7A issues, the ability to retain earnings, asset protection, the ability to access certain R&D concessions and the corporate veil.
- The benefits of using a family trust are: flexibility in estate planning, streaming of income and the ability to access the CGT discount.
- Family trusts are not commonly used as the head trading entity in a business structure as it restricts the ability to raise capital and introduce new investors.
- Whilst family trusts may provide flexibility in estate planning, limitations of this arise where family members who are active participants in the family business want an equity interest in the business prior to their parent's passing. Another limitation arises where control of the trust is bequeathed to multiple parties who have conflicting interests and the assets of the trust are illiquid and must be sold.
- Division 7A was highlighted as a major issue and that billions of dollars are sitting in bucket companies, which will have to pay 'locked up tax' – often clients are unaware of this issue.
- The prevailing view was that the use of family trusts as a trading entity will continue to decline in popularity, but that trusts will continue to be used for a number of other reasons in the future.
- The uncertainty surrounding tax issues such as the reduction in the CGT discount from 50% to 25%, changes to franking credits, the proposed 30% trust distribution tax were all highlighted as issues that advisers are paying close attention to in light of the proposed Labor policies.

Discussion

1.	**Which business structures are most commonly utilised by your clients? What do you see as the benefits of these business structures over the use of a family trust?** The consensus was that common business structures involve a number of different entities – often being a combination of companies and discretionary trusts. One adviser stated that a typical basic structure would be: a company carrying on the business and the assets associated with the business (land, plant and equipment) being held in a discretionary trust. There would be an arrangement between those two entities. As a result, the structure has the benefits of the CGT discount, a separation regarding asset protection and the corporate tax rate. In any case, it was noted that often the shareholder of the company carrying on the business would be a discretionary trust – meaning that streaming opportunities arise with respect to profits at the company level. It was noted that the benefits of using a company are the ability to use franking credits, a reduced tax rate, potentially less Division 7A issues, the ability to retain earnings, asset protection and the corporate veil. It was also mentioned that companies have purely commercial benefits such as being simple to understand and easier for a purchaser to acquire. For trusts, the benefits were flexibility in estate planning and the ability to use the CGT discount. With respect to family law, it was stated that the prevailing view is that 'nothing is really protected any more', including family trusts. Discussion surrounding the use of partnerships concluded that their use is currently uncommon – save for in the context of a professional practice, which would usually be a partnership of trusts. There are still partnerships on foot which were set up a long time ago – especially in rural businesses. It is anticipated that use of discretionary trusts as the 'head entity' of a structure, i.e. the trading entity – will become rarer in the future. However, it will likely continue to be used as a shareholder of the trading entity (which would be a Company).
2.	**What are the common characteristics that you take into account when advising clients to structure their business in a family trust?** The main characteristics noted were:

Ability to raise capital

Limitation of liability

Exit plan

Succession planning

- e.g. being able to package of related assets to be passed to certain members of a family group.
- It may be difficult to pass assets to next generation that are held in family trust – depending on who controls the trust.

Tax

- It was agreed that minimising tax is the most important factor.
- The prevailing trends are making trusts less attractive. One adviser noted a recent example where they advised a client to put appreciating assets in a company based on modelling that showed it would be more tax effective than a trust – which was against the common practice of previous years.
- However, it was also acknowledged that the changing tax environment is significant and that trusts provide flexibility.

Access to grants and concessions

- It was noted that access to grants and concessions, for example the R&D concessions are only available to companies.
- Businesses carried on through a trust are not able to access the R&D concessions.

Ability to introducing new investors

- The consensus was that it is extremely difficult to introduce new independent investors into a business carried on through a family trust. The usual course would be to restructure to a company before doing this.

It was agreed that it is part of the adviser's role to advise client that their circumstances may change and that flexibility should be encouraged. The advisers also highlighted the difficulty in advising clients whilst areas of tax law may be subject to reform: cf changing the CGT discount from 50% to 25%; Division 7A; use of franking credits.

From an estate planning perspective – it may be difficult to pass assets to the next generation that are held in family trust. One adviser noted that it is not common for parties consider their death and succession plan at the time of commencing a business.

It was also noted that cost is a factor. It may be that the ideal structure isn't used due to cost. For example, one adviser noted that a business may start as a partnership because the startup costs are almost zero.

3.	**What are your clients most concerned about when choosing the right business structure for their business?** Often, simplicity of structure is important for the client. They may want a simple structure that they can understand. However, other clients may be happy to hand responsibility to the adviser to take care of the structuring and operations from a legal perspective. It was noted that different clients have different levels of sophistication. One adviser mentioned that the client looks to their adviser to make decisions and that a constant education process with the client is necessary: for example, regarding their rights and obligations, making resolutions etc. It was highlighted that there is a distinction between the role of a lawyer and accountant. It was noted that it may be that the lawyer assists the client to set up and then have little interaction with the client after. On the other hand, the client may have a great deal of dependence on their accountant to administer and look after their business structure and relevant lodgments.
4.	**Is a family trust a good business structure for a small family business? Which other structures would work for a small family business?** As in Q1 – it is likely to be used in conjunction with one or multiple companies as part of a larger business structure.
5.	**Would you ever recommend the use of a family trust as a business structure for unrelated parties?** The consensus was no (e.g. due to family trust distribution tax applicable to streaming outside of the 'family group'). Cf discussion at Q15. However, partnerships of trusts or unit trusts where the unitholders are family trusts are not entirely uncommon.
6.	**Are your family business clients driven by any non-economic considerations when deciding on their preferred business structure? In what ways does a family trust assist business families in achieving their non-economic objectives?** It was noted that it is significant to consider succession planning and exercising control over what happens to assets when deciding an appropriate structure.

	A common example noted concerned which child (in a farming family) takes control of land. In this scenario there is 'one highly valuable asset (land), without which the business cannot operate and these are often business that have gone on for many generations'. Hence, looking at the next generation is a significant factor in structuring in these situations. It was noted that primary production is an outlier to some degree due to the multi-generational nature of the business – the parties are concerned with the control of the asset (the land). One adviser noted that family trusts are not good at dividing wealth where the parties do not 'get on'. The adviser cited a recent example where the assets of the trust had to be sold, resulting in CGT issues. However, the parties were happy as they received assets on an equal basis. It was noted that many of issues around passing on assets via a family trust can be resolved by appropriate drafting of the Trust Deed that allows for the passing of the control (appointor, trustee) of the trust. One adviser noted that, in comparison, 'for a company control and ownership is the same thing – whereas for a trust, control and ownership are separate'.
7.	**Do you think your clients have a good general knowledge as to how family trusts operate, and their rights and obligations under the relevant trust deed and/or at common law? Or do they rely solely on you as their trusted adviser?** Cf discussion at question 3.
8.	**Australian Bureau of Statistics data suggests businesses operated through a trust structure have a higher survival rate when compared to other business structures. Is this consistent with your experience and why?** One adviser suggested that this may be due to family trusts often being used as leasing/ property enterprises which often have lower risks attached. It was also noted that due to the corporate veil, business operators may be willing to have the company fold. One adviser also noted that the motivations of clients is significant. Family trusts may be used with the desire to set up the next generation, whereas a company may be used by arm's length parties carrying on a business. Family trust capital was described as 'patient' capital where the proprietors are willing to take losses for an extended period when compared to arm's length parties carrying on business through a company.
9.	**In your practice, how common are businesses structured as partnerships of family trusts or other hybrid structures incorporating a family trust(s)?**

	As per Q1 – the most common structure is a mixture of discretionary trusts and companies.
10.	**How can family trusts be incorporated into other business structures? i.e. ownership of shares, SMSF and business real property etc** It was mentioned that trusts can be very useful for holding pre-cgt assets, as to not crystalise a gain upon death.
11.	**In which situations would you advise your clients to restructure from a family trust into an alternative structure?** It was noted that this would occur when outside parties are being introduced to the business, or raising capital. Cf discussion around Div 328-G rollovers at Q23 and Q25.
12.	**What are some of the commonly cited issues or difficulties experienced by your clients with respect to family trusts?** Discussed the limited ability to pass assets down whilst controller of trust is still alive – i.e. where the children want the money 'now' or an ownership interest 'now' as they have contributed to the business. It was agreed that it is a significant limitation of family trusts.
13.	**What is your general approach when advising clients who are structured in a family trust as to their succession plan?** One adviser referred to an example where a mother owned a business and the son wanted ownership. Control of the trust was transferred to the son and his share of her estate was equalised so that the daughter's share of the mother's estate was larger. However, it was noted that the extent to which this is effective is subject to the will staying the same, meaning a significant amount of *trust* between the parties is required.
14.	**Is it more difficult to execute a succession plan in a family trust structure when compared to other types of business structures?** It was stated that it depends on the number of assets and number of beneficiaries (and how they get along). One example mentioned was of a person with a trust, who left control to his three daughters (as directors of the corporate trustee). Inevitably the daughters did not agree with how the estate should be divided – and hence any two daughters

	could cut out the third by calling a meeting and resolving to remove her as director. Another adviser had a similar example where the asset in question was illiquid and the trust had to wind up to pay out the three beneficiaries under the estate. It was stated that the difference with shares in a company was that the beneficiary has an asset that they can sell, rather than merely being an object of a discretionary trust, where you essentially 'have nothing'. One adviser also mentioned that shareholders of a company have certain protections under the Corporations Act, for example with regard to shareholder oppression.
15.	**Is a family trust structure problematic if a business is trying to raise capital (using debt, equity, and/or bringing in an outside investor such as a PE firm)? Are these issues easy to overcome?** The consensus was that only debt can be raised using a family trust. It was also noted that raising debt is more difficult – the banks will want more information and to look over trust deed. However, the main concern is the underlying security. Hence, to raise capital the structure must be changed from a family trust – usually to a corporate structure, although a partnership may be used in rare circumstances.
16.	**How common are disputes concerning family trusts? Which parties to the trust are typically the ones to initiate the dispute?**
17.	**What are your main concerns with respect to the income tax consequences of a business that is being carried on in a family trust?** It was noted that streaming of capital gains is only applicable in trust scenario due to ability to stream. Company has no ability to stream in this regard – either it pays a dividend or it doesn't. *Bamford* and subsequent legislative mechanism have meant that advisers are now looking to the legislation to comply with streaming requirements. Prevailing view was that *Bamford* is largely limited.
18.	**What are the difficulties in being able to access the CGT small business concessions in a family trust business structure?** It was agreed that the ability to access the concessions will influence structuring. The general position is to hold appreciating assets through a trust.

<table>
<tr><td></td><td>It was mentioned that the 20% rule (cgt concession stakeholder) requires advisers to look at the facts in great detail. Often the adviser requires a crystal ball to advise at the start as the rules are so prescriptive and change over time.

The consensus was that there is more confidence around general discount as its been around for a long time – whereas other concessions may not be around long term. The CGT discount is a ‘big factor’ in deciding to use a trust structure.

The difficulty that arises around the changing law was highlighted – and that advisers can only really advise on the law at the present whilst flagging potential future changes.

It was agreed that trusts are generally more flexible, whereas for example, the Corporations Act applies to companies. With a trust, there is an ability to stream income versus shares where dividends are generally paid on a pari passu basis to shareholders.

This was highlighted by an example provided by an adviser: a client wanted to make trust distributions equally to his daughters despite the fact that it would result in paying more tax in total. It was highlighted that the client was able to make the choice (to distribute the income of the trust equally, or on the most tax-effective basis), whereas if the daughters held shares in a company, there would be no choice.</td></tr>
<tr><td>19.</td><td>What is the approach of the ATO and Revenue SA when dealing with family trusts as business structures versus other types of business structures?

Rules suggest that ATO and RevenueSA don’t like trusts. For example, certain restructure reliefs are not available where a trust is involved.

It was noted that often trusts are seen as potential ‘anti-avoidance’ vehicles.

One adviser mentioned that the ATO and Revenue SA stick to their mandate of collecting tax – and therefore dislike trusts as they may be used to minimise tax.</td></tr>
<tr><td>20.</td><td>What are your primary concerns with the operation of Division 7A and Unpaid Present Entitlements?

The main concerns mentioned were:
Challenges in reinvesting into trusts – with ATO’s higher interest rate – which is higher than arm’s length rate.
Distinction between using profits for personal benefit versus for reinvestment. The reinvestment point is that it is much more difficult and causes problems. It was noted that clients do not understand why there is a problem – as the money was reinvested into the business.
Many within the tax office see the company having lower rate of tax and trust can access discount and that UPE is a mixing of the benefits that</td></tr>
</table>

	was not intended. One adviser summarised the ATO view as being: 'you either use your corporate vehicle and have a lower rate of tax and reinvest the profits, or you have a trust with a CGT discount which is not available for a company and pay a higher rate of tax'. • Pre-2009 UPE changes will cause issues; e.g. pre-2009 gain by trust, distributed to company. It was noted that there are billions of dollars of UPEs in bucket companies. • Div 7A issues may result in restructuring – many clients don't realise they have a Div 7A issue. Some may result in next generation having to deal with the issue. One example was: • Before 2009, a trust made a profit (approx. $12 million) and instead of distributing it through to a company. It was sitting in the company, so that the company had an asset being a receivable of $12 million and retained earnings of $12 million. • If proposed changes are implemented, a Div 7A loan agreement over 10 years may have to be entered into and 'the locked up tax will have to come out over a 10-year period [effectively] as a dividend'. • It was noted that in the above example, the amount may have to come out of working capital – which is an impediment on the business. The consensus was that rollover provisions are now commonly being used to restructure where Division 7A issues have become a significant problem. It was noted that a long term strategy is required to deal with Division 7A as part of effective succession planning.
21.	**Do the trust vesting rules impact on many of your clients who are carrying on a business in a family trust? Can any adverse tax consequences resulting from the vesting of their family trust be easily avoided?** Many trust deeds have the old vesting date – or have already vested. ATO view is that variation before vesting is acceptable (relevant in SA where rule against perpetuities has been abolished). Interstate it is arising as an issue now and also arises in SA where trusts hold assets across multiple jurisdictions and the proper law of the trust must be considered. Businesses aren't considering a vesting date when they set up generally – tradeoff between flexibility and rule of perpetuities.
22.	**When would you advise your clients to make a Family Trust Election?** Where there are losses and/or franking credits. The general consensus was to hold off as long as possible before making a FTE.

	Poses issues when attempted to include an outside party into a structure. From a succession planning perspective – may be challenges where there is a large group. An example provided was where a company made IEE and was then sold to a 3rd party – this then became an issue for the purchaser as IEEs are irrevocable.
23.	**Are there any adverse tax or other consequences that may arise in a family trust structure versus other business structures upon the death of a principal of the business?** The adverse tax consequences noted were: • R&D Concessions: requirement to restructure. Grants and concessions – must be a company at setup; • Superannuation – wouldn't distribute from discretionary trust to super fund. There are scenarios where family group will enter into investment of sorts where a portion will come from family trust and SMSF (i.e. unit trust) – but is subject to different rules. It was also noted that: • Division 328-G rollover relief has been a major reason for making FTEs. For example, for a general manager to buy-in to a business; setting up a holding company to strip retained earnings out of business, using a number of rollovers. • Companies have been set up to deal with div 7A issues.
24.	**Do you think the use of family trusts will grow or decline in the future? Why?** The consensus was that the use of family trusts is likely to decline– but there is uncertainty. It was noted that a different environment will emerge – there will still be use of trusts around the new boundaries – but possibly for different reasons.
25.	**Are there any other issues we should be aware of with regard to operating a business through a family trust?** Upcoming changes in the Election: • CGT discount reduction from 50% to 25%– will impact family trusts; and • 30% rate on trust distributions – there is uncertainty on what the actual policy is. It was put forward that the 'simple answer is: yes, changes will affect us, but the question is how?'

	Final thoughts: • Family trusts are an important vehicle for long term family wealth creation – but the gap is narrowing regarding tax benefits. There will always be other benefits that drive the use of family trusts. • Family trusts enable families to pool their resources and manage tax liabilities from a family unit perspective.

APPENDIX 4

Minutes of Roundtable 2 (10 May 2019)

Family Trust Roundtable #2
Held at the University of Adelaide on 10 May 2019
MINUTES

The Family Trust Roundtable #2 took place at the University of Adelaide on Friday, 10 May 2019. There were ten participants, four accountants and six tax lawyers all having many years' experience in advising small businesses and family enterprises. For simplicity, these participants have been referred to as 'advisers' in the Minutes.

Executive Summary

- The most common business structure involves a combination of different entities – including companies and family trusts. Most commonly, trusts are preferred for holding equity and appreciating assets like land, whereas a company is preferred as the trading entity.
- The most common structures to use were (2) and (4), whereas (3) may be used to hold land. Number (4) was generally preferred over (3) where the facts were applicable due to its 'flat' structure.
- The difficulty in applying the taxation legislation to 'hybrid' structures was identified as an issue. For example, such a structure may not be able to access the small business CGT concessions.
- The prevailing view was that there is a lack of understanding with respect to how trusts work in the wider community, including by some members of the accounting profession.
- The consensus view was that the main reasons to include a trust in a business structure are minimisation of tax (income streaming and access to CGT discount), estate planning and flexibility.
- Concerns around using a family trust include how third parties (e.g. lenders) treat the structuring and whether the business will trade internationally. It was highlighted that companies are much simpler in this regard and may be treated favorably by Banks.
- The benefits of using a company are: the ability to use franking credits, a reduced tax rate, potentially less Division 7A issues, the ability to retain earnings, asset protection, the ability to access certain R&D concessions and the corporate veil.
- Whilst family trusts may provide flexibility in estate planning, limitations of this arise where family members who are active participants in the family business want an equity interest in the business prior to their parent's passing. Another limitation arises where control of the trust is bequeathed to multiple parties who have conflicting interests.
- Restructures to a company are common to simplify the business structure or to prepare a business for sale/outside investment. Common rollovers used include: Division 122-A, 124-N, 328-G and scrip-for-scrip. The small business CGT concessions may also be used in a restructure.
- Division 7A was highlighted as a major issue. The prevailing view was that Div 7A has, over time, changed from being an anti-avoidance provision to an assessing provision. It is expected that upcoming changes to Division 7A may cause significant cash flow issues for businesses.
- The popularity of family trusts is expected to remain the same or increase due to its benefits of flexibility and in estate planning. Testamentary trusts are also expected to rise in popularity.

CHOICE OF BUSINESS STRUCTURE

1. **Which business structures are most commonly utilised by your clients? (Sylvia to work through diagram of most common business structures and spend some time working out what motivates that choice – assessing trade-offs). Are there any common structures involving family trusts we have missed?**
2. **How often would you set up a business structure for a small or family business that does not incorporate a family trust somewhere in the structure? What structure is this likely to be and why?**

The consensus was that accountants commonly propose the use of structure (1), however when there is the prospect of bringing in new investors the most common structure would be (4). It was also observed that structure (3) is commonly used for holding land or other appreciating capital assets. One advisor noted that structures (2) and (4) are easy to sell as companies, whereas other structures would require an asset sale, which is more complicated. There was discussion surrounding where a 'flat' structure may be preferred, meaning structure (4) may be preferred over (3) – but this would depend on nature of the assets held by the taxpayer.

It was the consensus that companies have started to become more popular since 2009, post UPE changes. Trusts are no longer the main trading entity but are still in the structure – and will almost always be involved as a shareholder. The position was summarised by one advisor as 'trusts are plan A for equity, companies are plan A for the business'.

There was significant discussion surrounding the lack of understanding amongst clients regarding the distinct characteristics of companies versus trusts. For example, one advisor noted that a client may be unsure about the difference between a corporate trustee and company 'in its own right'. The lack of understanding in the wider community around structuring issues, including by some members of the accounting profession, was identified as a problem.

Another issue that was highlighted was the use of 'hybrid' structures – being, a company with multiple classes of shares or a discretionary unit trust. One advisor noted that 'hybrids' cause a problem when trying to apply the tax legislation to them (not only income tax but also stamp duty). For example, when trying to access the small business CGT concessions.

3. **What are your clients most concerned about when choosing the right business structure for their business?**

The consensus was that non-tax factors that clients were concerned with include:

- how third parties treat the structuring (for example lenders and potential investors);
- whether the business may trade internationally.

One advisor noted that recently, on three separate occasions, Banks had requested that every potential beneficiary of a discretionary trust be identified and sign off on documents. It was the consensus that employees of Banks are not entirely aware of how a trust works. A related issue that was identified is that there is no ‘standard’ trust deed – which means that Banks will always want to see the specific deed.

It was also noted by one advisor that if the relevant business seeks to trade internationally, they will have to trade through a company, as trusts are not well understood overseas and complicate matters.

Other benefits mentioned included income streaming and asset protection, but the consensus was agreed that the use of a trust over a company is often driven by tax and the need for flexibility.

4. **Are your family business clients driven by any non-economic considerations when deciding on their preferred business structure? In what ways does a family trust assist business families in achieving their non-economic objectives? i.e. making distributions to children on a needs basis.**

The consensus was that in years gone past, the use of trusts has been highly tax driven, however now the main concern is often estate planning. One advisor noted that nowadays, super may be instead used for tax-driven purposes.

It was noted by one advisor that land tax grouping applies differently in South Australian than in New South Wales. It was noted that it is easier to prevent land tax grouping applying in South Australia. Furthermore, it was noted that ‘notional estate’ in NSW would make many of the uses of trusts for estate planning outdated.

The use of trusts was highlighted as a useful estate planning tool. One advisor noted a recent example involving a trading trust with a corporate trustee run by a mother and father who handed the business down to their son. The transfer of the business to the son was seamless: they appointed the son as the appointor of the trust, transferred the shares in the corporate trustee and changed its directors – so there is no CGT event.

However, it was also noted that trusts can cause significant difficulty in estate planning scenarios. It was also noted by one advisor that there may be conflict issues and difficulty to identify who the client is. For example, the entire family acting as one economic unit is OK, however there may be difficulty where the client is only the children who will receive a transfer of assets from their parents.

One advisor noted that in the past 12 months they have seen a number of transactions where there are significant asset transfers from parents to children, which have resulted in the parents being bereft of any economic sustenance. In these situations, it was noted that the children are generally not giving arm’s length *or any* consideration for these transfers – they are ‘gifts’. One advisor noted that many difficulties arise where parents are financially dependent on their children – and it causes relationship breakdowns. *Rodda* and its implications were discussed.

With respect to succession was further elaborated on and it was noted that this is primarily an issue where there is multiple children or families involved. One advisor noted that the addition of one family member or spouse can change the family dynamic completely.

One advisor summarised that the ‘defining feature of a trust is flexibility – and it can cut both ways’: where there is one controller of the trust is works brilliantly, but where there are multiple controllers there is difficulty.

5. Do you think your clients have a good general knowledge as to how family trusts operate, and their rights and obligations under the relevant trust deed and/or at common law? Or do they rely solely on you as their trusted advisor?

See discussion at question 1 and 2. The consensus was that clients do not have a good general knowledge as to how family trusts operate and their rights and obligations.

6. Australian Bureau of Statistics data suggests businesses operated through a trust structure have a higher survival rate when compared to other business structures. Is this consistent with your experience and why?

CONFIGURATION AND USE OF FAMILY TRUSTS

7. In which situations would you advise your clients to restructure their business?

The main reasons identified for a restructure were:

- to enable the addition of new investors into the business;
- to access the R&D concessions; and
- to prepare a business for an eventual sale.

It was also noted that it may be the case where there is a ‘weird structure that has been accumulated over time’ and that a restructure may be used to ‘clean this up’.

8. Which of the diagrams above are they most likely to restructure into and why? Or would you restructure them into some other business structure and why?

9. Are you able to effect most restructures without incurring any tax liabilities – which tax concessions are you accessing?

The common restructures mentioned were Division 122-A, 124-N, 328-G, scrip-for-scrip and the small business CGT concessions.

The consensus was that there are usually no tax consequences of restructuring and that a client would not want to restructure if there is a tax cost.

10. What happens when Mum and Dad wish to retire and pass control of business when alive? (or kids demand an ownership interest) How do you keep everyone happy? Are you able to avoid the imposition of a tax liability?

See discussion at Q4.

11. **What advice do you give clients with respect to their structure when they want to introduce someone else into the business? What motivates them to introduce someone else into the business?**

See discussion at Q1 re: introducing new investors and discussion at Q8/9 around use of rollovers to companies.

12. **What happens when Mum and Dad wish to retire and pass control of business when alive? (or kids demand an ownership interest) How do you keep everyone happy? Are you able to avoid the imposition of a tax liability?**

See Q4.

13. **What is your general approach when advising clients who are structured in a family trust as to their succession plan? (Sylvia to refer to diagrams of each common structure).**

See Q4.

14. **Is it more difficult to execute a succession plan in a family trust structure when compared to other types of business structures?**

See Q4.

15. **How common are disputes concerning family trusts? Which parties to the trust are typically the ones to initiate the dispute?**

See Q4.

16. **What are some of the commonly cited issues or difficulties experienced by your clients with respect to family trusts? What are the solutions to these issues?**

TAXATION ISSUES SURROUNDING FAMILY TRUSTS

17. **What are your main concerns with respect to the income tax consequences of a business that is being carried on in a family trust?**

The main issues identified surrounding the use of a family trust in a business structure were Division 7A, capital gains tax, income streaming and flexibility.

One other issue identified was the need for certainty. For example, one advisor noted that even if the removal of franking credit refunds is a good policy, it has not been changed for 25 years and people have planned their retirement around it. Another advisor noted, ‘retrospectivity is bad law’.

One potential solution proposed which may solve a number of policy problems was ‘family unit tax’ or income averaging between spouses – which have been implemented in foreign jurisdictions.

Discussion also surrounded the increasing popularity for testamentary trusts – largely due to the concessions that attach to these trusts.

18. What are the difficulties in being able to access the CGT small business concessions in a family trust business structure?

See discussion regarding hybrids at Q 1.

19. What is the approach of the ATO and Revenue SA when dealing with family trusts as business structures versus other types of business structures?

There was discussion surrounding the a 2013 ATO Ruling that considers the meaning of income for tax and trust purposes. It was noted that the Ruling is still in Draft form. One of the major issues identified with respect to the environment in which trusts operate is that there is a lack of interest and understanding in the general public.

20. What are your primary concerns with the operation of Division 7A and Unpaid Present Entitlements? What are some possible solutions?

It was the consensus that the biggest concern is with respect to pre-1999 loans that have been 'forgotten about' and where repayment of the loans causes cash flow issues.

Other issues of concern that were identified were:

- The increase in the Division 7A interest rate, and that it is significantly higher than the market interest rate. One advisor noted that this will impact a number of division 7A strategies dramatically.
- 25 year division 7A loans, to the extent to which they exist, will be reduced to 10 year loans and will cause cash flow issues.
- There were queries as to how loans that were 'frozen' due to distributable surplus in the past will be treated.

The otherwise deductible principle was posited as an attractive solution. In the future, it was the consensus that wealth should only leave a family group by way of dividend.

One advisor noted that Division 7A, in various forms, has existed for over 50 years. Another advisor noted that there has been a large shift over this period from Division 7A as an anti-avoidance provision, to Division 7A as an assessing provision.

21. Do the trust vesting rules impact on many of your clients who are carrying on a business in a family trust? How does trust vesting work with respect to property owned in multiple jurisdictions? What are some possible solutions to the trust vesting problem?

22. How common is it to deal with a client that has trust losses? Are the trust loss rules easy to work through? When would you advise your clients to make a Family

Trust Election? What are the issues concerning trust losses and succession? If dealing with trust losses is a problem, what are some possible solutions?

One issue identified was where losses exist in various trusts in a larger group – for example when they have been structured for land tax minimization with multiple trusts.

The consensus was that where there is a prospect of losses, franked dividends or intra-group distributions, a family trust election should be made.

23. How will a new government's proposal for a reduction in the CGT discount and 30% tax rate for beneficiaries' impact on the above discussion?

It was the consensus that trusts will continue to be used for the reasons of: asset protection, estate planning and control over distribution of income. It was agreed that this would be the case even if trusts lose all tax benefits.

CONCLUDING QUESTIONS

24. Do you think the use of family trusts will grow or decline in the future? Why?

There was a suggestion that the use of family trusts may increase in the future.

There was discussion around the tax rate for pension income. The significance of the pension earnings tax exemption given the portion of national wealth and income contained within superannuation was noted. One advisor suggested that a tax rate of 10% on pension income may have been an alternative to Labor's franking credit policy. Another advisor noted that it may have been an alternative solution to the $1.6 million transfer balance cap

25. If all tax benefits of trusts over companies were removed would trusts still be utilized as part of a business structure?

Cf. Q 23.

26. Are there any other issues we should be aware of with regard to operating a business through a family trust or where a family trust is part of the overall business structure?

There was discussion surrounding discretionary trusts and pensions. Where parents are on a pension and the children operate a discretionary trust. It was noted that it is extremely difficult to be entitled to a pension under the current law. It was put forward by one advisor that there may be hundreds of thousands of people who are receiving a pension who are not actually entitled to them.

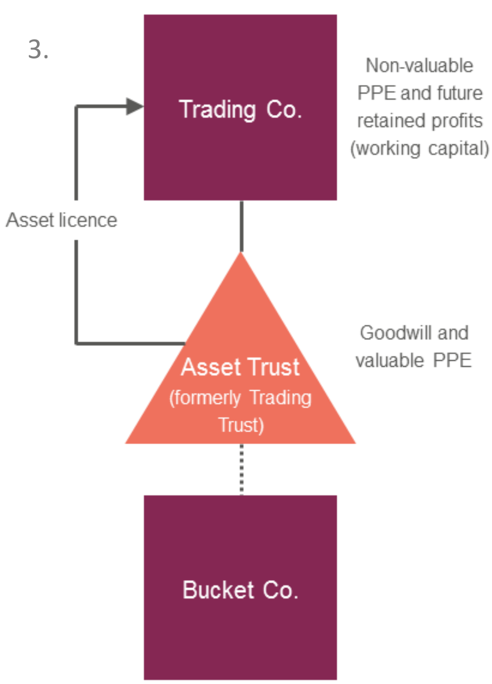
APPENDIX 5

Business Structures Handout for Roundtable 2

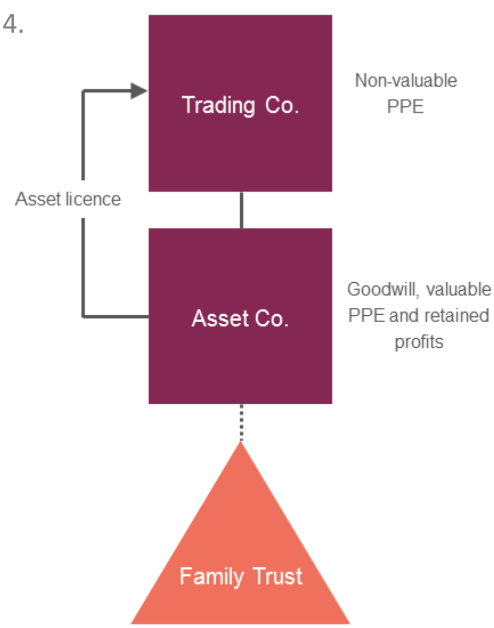
1. Family trading trust distributing to bucket company

2. Trading company owned by family trust

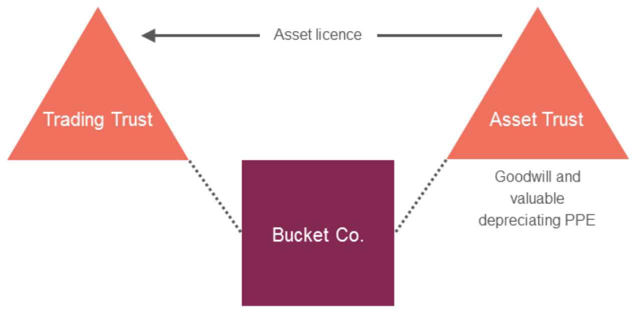
3.



4.



5.


Asset licence
Trading Trust
Asset Trust
Bucket Co.
Goodwill and valuable depreciating PPE