It's all about trust!

It's likely you've heard people talking about holding investments in a family trust. Have you ever wondered if a trust would be appropriate for you? There's a lot to consider in order to use a trust effectively. Let's take a closer look.

What is a trust and how does it work?

A trust is not a legal entity in itself. Instead, it's simply an agreement to hold assets for the benefit of certain people (beneficiaries). Assets are held in trust until they are distributed to beneficiaries. Many trusts will have the following attributes:

- Trust deed – a written document setting out the terms and conditions of the trust (i.e. how the trust is to be operated).
- Beneficiaries – the people that can benefit from the trust (i.e. receive a distribution). Beneficiaries can be named (i.e. the persons' name is included in the Deed) or unnamed (the person is described, such as "all blood children" of a certain person).
- Trustee – the legal entity that holds the assets in trust. A trustee can be a natural person/s or a company. Often, it is best to have a company – more on this later.
- Appointer – this is the person that can hire and fire the trustee. This is quite an important party.
- Settler – this is the person that starts the trust with a gift.

There are three types of trust. Firstly, a discretionary trust (often referred to as a family trust) is a trust where the Trustee has full discretion on how income and capital is distributed. Second is a unit trust. A unit trust is a fixed trust in that the beneficiaries' entitlement is fixed depending on the amount and type of units held (much like shares in a company). Lastly, a Hybrid Discretionary Trust (HDT) which is a combination of both. A HDT can issue units to create a fixed entitlement or, if no units are on issue, the Trustee can have complete discretion over how distributions are made.

As a trust is not a legal entity, it must distribute all profit at the end of the year. If a trust does retain undistributed profit, the profit is taxed at the penalty rate of 46.5%.

Some important considerations many people overlook

If you're an investor who uses negative gearing (i.e. borrowing a proportionally high amount to fund investments), one of the biggest downsides to using a discretionary trust is that you will not be able to benefit from the negative gearing benefits. The reason for this is that a trust cannot distribute a loss, only a profit. Therefore, if you own an investment property in a trust and that property produces a loss (i.e. the interest cost is more than the rental income received), the loss will have to remain in the trust and carried forward. This loss can be offset against future profitable years. If structured correctly, a unit or HDT can shift the negative gearing benefits into a person's name.

Discretionary trusts provide the best asset protection (compared to unit trust and HDT) as assets are held in trust and a beneficiary doesn't have claim to ownership of any trust property until it is distributed. Be careful with providing loans to a trust, as this will significantly weaken asset protection. However, a recent court case suggests the court may "look through" a trust structure to determine who controls the trust, so it's not bullet proof.

A unit trust can be an effective way of transferring property and avoiding stamp duty. For example, the highest income earner within a family can purchase an investment property using a unit trust. They can possibly benefit from the negative gearing benefits (which are normally enjoyed in the first 5 to 7 years of ownership) by personally owning all the units in the trust. Once the property produces a taxable profit, the highest income earner can sell the units to the lowest (or non) income earner. It's likely that Capital Gains Tax will be payable, but stamp duty should be avoided. The additional benefit of this transaction is that the investors can potentially 're-gear' the investment and pull out some cash to use for a non-deductible purpose. Whilst it may not suit everyone, our numbers suggest this can often be better than the same person owning the asset for its entire life.

The ATO has scrutinised the use of HDT by property investors, particularly in relation to investors generating negative gearing benefits. Therefore, we advise all clients considering using a HDT to obtain a Private Ruling from the ATO to eliminate this potential tax compliance risk.

The appointer of a trust holds a very powerful position and must be carefully considered. Specifically, the death of an appointer must be considered in the appointers Will and Trust Deed. This is often identified by estate planning lawyers. However, disablement is often overlooked. What if the appointer becomes disabled and unable to execute their responsibilities? The trustee deed needs to provide for these circumstances.

The settler of a trust should be an unrelated party. The reason for this is that it might be difficult for a settler to ever receive a distribution from a trust. Therefore, make sure the settler is a person you will never want to distribute money to.

We strongly advise all clients to use a corporate trustee instead of acting as individual trustees. The reason for this is to ensure it is clear (to the ATO and State Revenue Office) that the property is an asset of the trust, not a personal asset. Confusion can be created because property titles only record the Trustee's details and they don't mention the entity is acting as trustee for a particular trust. For example, a Contract of Sale is often signed as "Trustee Company Pty Ltd ATF The Family Trust", whereas the title is simply registered in the name of Trustee Company Pty Ltd.

If you establish a trust and then become a non-resident for tax purposes (e.g. you decide to work overseas for a few years), the taxing of distributions may not work effectively for you (and therefore a trust may not be appropriate). The reason for this is that the trustee must pay tax on distributions paid to any non-resident at 46.5%. The beneficiary obtains a tax credit so, if they lodge an Australia tax return, it will all wash out in the end. However, if the beneficiary chooses not to lodge an Australian tax return, then this could cause problems.

The cost

Trusts are reasonably cost-effective to establish. You can purchase a trust deed for $200 to $500. If you want to appoint a corporate trustee, you will need to establish a company which normally costs $600 to $800. The ongoing costs of a trust depend on the nature and size of investments and accounting requirements. A company needs to pay an annual fee to ASIC of $212.

To learn more

If you would like to learn more about trusts and other ownership structures, come to our seminars in Melbourne and Sydney in April and May. For more details visit **http://www.prosolution.com.au/news/2009.htm**

Warning: Major changes in lending

There's an article in the press about potential changes of property prices almost on a daily basis. To be honest, I am getting sick of reading them. I read one today that suggested the price of bricks and brickwork is inflated and expected to fall quite considerably. Consequently, prices of property should fall too. Give it a break! These articles are often written by people who don't understand property. Property values are often driven by land values. Most people realise that the value of dwellings actually depreciate over time. However. despite my better judgement, I am curious and will probably continue to read these stupid articles!

Many articles have cited rising unemployment as a key risk for the property market, which I partly agree with. As long as unemployment doesn't rise too much, I think unemployment will only affect certain geographic parts of the property market rather than the market as a whole.

I think a greater risk to the property market has emerged lately. That is, the restriction of credit to property buyers, particularly first home buyers. Over the past few months, we have seen many lenders restrict the amount they will lend borrowers to 90% of a property's value (down from 100%). Lenders that have changed this policy include Commonwealth Bank, ANZ and ING. I expect the other lenders will follow suit this year. The consequence of this policy is that property buyers now need a minimum of 15% deposit (i.e. 10% deposit plus approximately 5% for costs such as stamp duty).

These lending policy changes mean that the federal government's First Home Bonus (due to expire on 30 June 2009) will be far less effective. This may have a detrimental effect on the property market, particularly in the first home buyers' space.

I have proposed a solution to the government. I have suggested that they scrap the existing First Home Owners Grant Scheme and replace it with a First Home Owners Loan instead. The loan could be for a greater amount than the existing bonus, but the property purchaser will have responsibility for repaying the loan at some stage. The key attributes of the proposed scheme include:

- Maximum loan of $40,000 or 20% of the property's value.
- Loan is indexed to CPI.
- Repayments are not required in the first 5 years.
- Loan becomes fully repayable if the borrower sells the property or vacates (and rents it out).
- Loan repayments are compulsory after 5 years and loan must be fully repaid over a 25 year loan term. Extra repayments can be made at any time without penalty.

The proposed scheme is more targeted, as the current FHOG scheme allows first home buyers to spend the grant on anything (e.g. furniture, holiday, etc.). The First Home Owners Loan will go directly into the property market. Also, many people use the FHOG as a means to buy an investment property (because they only have to occupy the property for 6 months). This First Home Owners Loan scheme will guard against this behavior.

Click here for details of the full proposal.

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