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Understanding Trusts: A Comprehensive Guide

A Brief History of Trusts

Trusts have a long history, dating back to the time of the Crusades in medieval England. When landowners went off to fight, they would entrust their land and property to a trusted person (a "trustee") to manage on behalf of their families. This concept was later formalised by English courts, recognising that ownership and management could be legally separated. Today, trusts remain a powerful tool for asset protection, wealth management, tax planning, and succession planning across common law countries like Australia.

What is a Trust?

A trust is a legal relationship where one party (the trustee) holds assets for the benefit of others (the beneficiaries). Unlike a company which is a sperate legal entity, a trust is not a separate legal entity. A Trust is a relationship governed by the terms set out in the trust deed and the relevant trust law. A trust has several key roles:

THE KEY ROLES IN A TRUST

1. The Settlor

The **settlor** is the person who establishes the trust by gifting a small sum (often $10) and signing the trust deed.
Important Points:

- After creating the trust, the settlor's role ends, they must have no part in the trust,
- To preserve the independence of the trust, the settlor cannot not be a trustee, beneficiary, or appointor.
- The Settlor is normally your Accountant or Lawyer

2. The Trustee

The **trustee** is the person or company, legally responsible for managing the trust's assets and affairs. They must act in the best interests of the beneficiaries and strictly according to the terms of the trust deed and relevant law.

Trustee Duties:

- Manage trust assets prudently.
- Distribute income or capital to beneficiaries as allowed under the trust deed and trust and tax laws.
- Keep accurate records and lodge required tax returns.
- Act honestly, in good faith, and avoid conflicts of interest.

3. The Appointor

The **appointor** is one of the most powerful figures in a trust because they have the right to hire and fire the trustee. This is often the person who contributes the assets of the trust.

Key Features:

- They can remove a trustee who is not acting appropriately.
- They ensure the trust remains in trusted hands over time.
- In family trusts, this role is often reserved for key family members.

4. The Beneficiaries

Beneficiaries are the individuals or entities including companies and other trusts, who may receive income or capital from the trust.

Beneficiaries' Rights:

- Beneficiaries have the right to be considered for distributions.
- If they are made **absolutely entitled** to a share (meaning their entitlement is fixed, vested, and not subject to trustee discretion like amounts distributed to them and added to their beneficiary accounts), they can demand payment of their share at any time.
- Beneficiaries do not automatically "own" trust assets unless a distribution is made.

SPECIAL CONSIDERATIONS FOR MINOR BENEFICIARIES

Minors and Access to Benefits

When a **minor beneficiary** (usually under 18) reaches adulthood (often 18 or 21, and depending on the trust deed and jurisdiction), they may be entitled to draw their trust balance.

However, while minors may be **absolutely entitled** upon reaching the appropriate age:

- Trustees must still check the **terms of the trust deed** to confirm the minor's rights.
- Prior to adulthood, a **guardian or parent** may draw funds on behalf of the minor for **maintenance and education**, *only* if the trust deed permits this.

Thus, both the trustee and guardian or parent must always act in the minor's best interests and within the powers outlined by the trust deed.

THE IMPORTANCE OF THE TRUST DEED

The **trust deed** is the "rule book" for the trust. It outlines:

- How trustees are appointed or removed.
- How income and capital must be distributed.
- Beneficiary entitlements.
- Trustee powers and restrictions.

Always follow the trust deed. If trustees act outside the trust deed, they risk breaching their fiduciary duty, which can lead to legal action.

TAXATION OF TRUSTS IN AUSTRALIA

General Rules

In Australia, a trust itself usually does **not** pay tax. Instead:

- The trust income is generally **distributed to beneficiaries**, who declare it in their personal tax returns and pay tax at their own marginal rates.

The trust must lodge an annual **Trust Tax Return** reporting:

- Total income.
- Beneficiaries and their entitlement.
- Other required disclosures.

Minor Beneficiaries and Testamentary Trusts

Ordinarily, minor beneficiaries (under 18 years old) are subject to **penalty tax rates** on "unearned income" from trusts.
However, an important exception applies:

- If a trust is a **testamentary trust** (i.e., created under a Will following someone's death), minors may be taxed at normal adult rates on trust income.

This makes **testamentary trusts** a powerful estate planning tool to protect assets and reduce tax for young beneficiaries.

When the Trustee Pays Tax

The trustee might pay tax if:

- Income is not distributed to any beneficiaries by the end of the financial year, or
- Income is distributed to beneficiaries who are presently entitled but cannot be identified or cannot be taxed.

Trustee Tax Rate:

- The trustee pays tax on the **undistributed income** at the h**ighest marginal tax rate** (currently 45% plus Medicare levy).

Why we avoid this:

- Trustee tax is punitive.
- We prefer that all income be distributed appropriately before year-end to avoid unnecessary tax costs. We will assist clients prepare the need trust minutes to achieve the best outcome.

OTHER IMPORTANT TRUST MATTERS

Trustee Discretion

In **discretionary trusts** (family trusts):

- The trustee has broad discretion to choose how to distribute income among the beneficiaries each year.

In **unit trusts**:

- Each beneficiary holds a "unit" representing their share and distributions must follow the unit holdings.

Record Keeping

Trustees must:

- Maintain proper records.
- Prepare resolutions documenting income distributions before **30 June each year**.
- Retain copies of tax returns, financial statements, and trust deeds.

Changing Trustees or Deeds

- Changes should always be carefully documented.
- Changes to the trust deed must be allowed under the existing deed and should not trigger unwanted tax or stamp duty consequences. Be sure to obtain specialist advice before making changes to your trust deed.

CONCLUSION

Trusts are flexible and powerful structures but must be managed carefully and in strict accordance with the trust deed and the law.

Every person involved—settlor, trustee, appointor, and beneficiary—has specific rights and obligations.

Tax law interacts heavily with trusts, and careful planning is required each year to avoid penalties, excessive taxation, and compliance breaches.

Professional guidance is critical.

Always seek advice before making decisions about trust income, distributions, or trustee appointments to protect the trust's assets and the beneficiaries' interests.

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