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NOTES REGARDING TRUSTS AND COMPANIES

DISCLAIMER:

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COMPANIES (Discussion limited to Australian jurisdiction Proprietary Limited (Pty Ltd) entities).

A company is a separate legal entity and can perform most commercial dealings as an individual would. A company is governed by its constitution and the Corporations Laws.

A company can be formed as a single shareholder company where that shareholder is also the company director and company secretary. Alternatively two or more people can act together and incorporate a company and have two or more directors and other shareholders.

BASIC STRUCTURE OF A COMPANY



OPERATING A COMPANY

The company is a separate legal entity and trades in its own right.

The company must maintain proper financial records that are in a form suitable for audit. Most private companies are not audited but the Corporations Law requires companies to maintain appropriate records. It is also best management practice to ensure that the records are complete and maintained in a form suitable for review if not audit.

The company should open its own bank account and steps should be taken to keep personal funds and company funds clear and separate from each other.

It is a clear responsibility for the directors and office holders of a company to act in the best interests of the company and its shareholders. Personal liability can be placed on the directors and senior officeholders for the debts of the company if the company trades while insolvent. To be insolvent is

to be unable to pay the company debts as and when they fall due. Other areas of risk for those involved in management of the company are in the conduct of negligent or illegal activities and again personal liability may be imposed by the courts.

Borrowing from your company should be avoided. Shareholders who borrow from a company are subject to Division 7A of the Income Tax Assessment Act (ITAA) and must have loan agreements in place, pay interest on the loan and repay the loan within 7 years if unsecured by a property mortgage or up to 25 years if a mortgage over a property is held. The Tax Office advises the applicable rate of interest each year.

Shareholders who borrow from a bank or other entity and use those funds to acquire shares in a company will generally be entitled to a deduction for the interest paid on that loan. There must be an expectation, genuine and realistic, that the shareholding will produce income in the future to obtain this deduction.

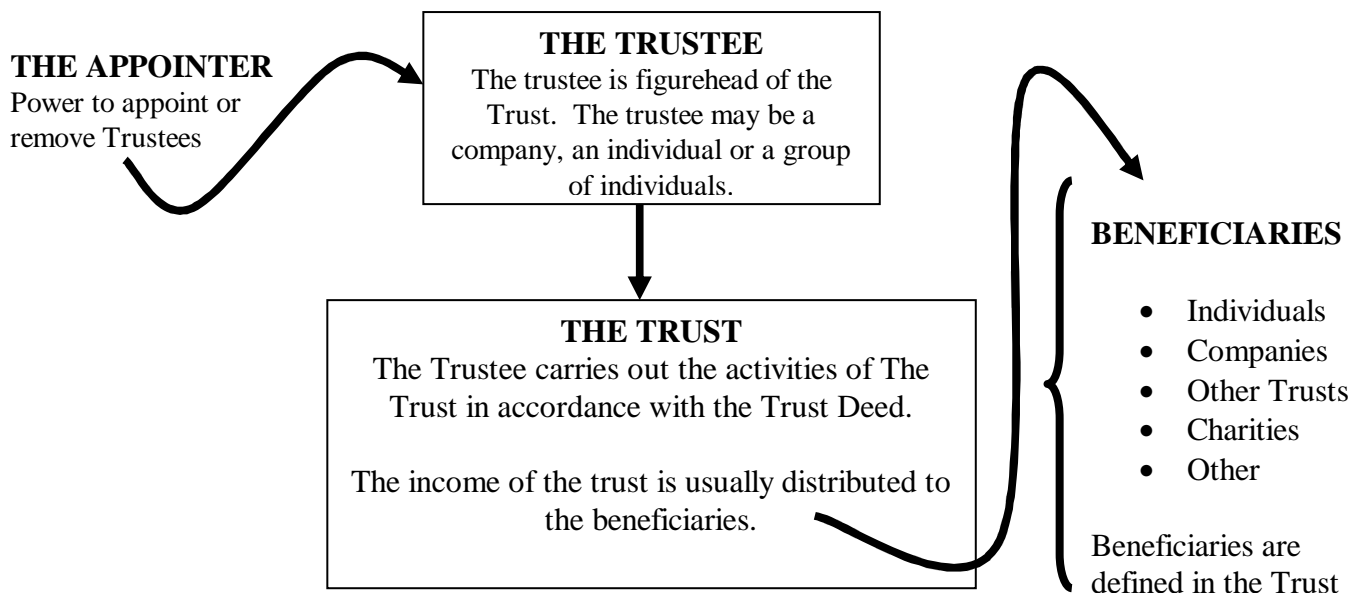
Profits are taxed in the hands of the company and losses are retained in the company until profits are generated to absorb those losses.

Tax paid by a company is recorded in an account known as a franking account. Dividends paid to shareholders have access to this company tax in the form of Imputation or Franking Credits attached to dividends that are paid. This removes double taxing of the company profits by allowing the shareholders to reclaim the tax paid by the company when the dividend is declared in their personal tax returns.

TRUSTS (Discussion limited to Australian jurisdiction entities).

The establishment of a trust will give rise to a number of important commercial and legal consequences of which users must be aware. There are aspects relating to the management and administration of trusts which involve a degree of careful attention to ensure that the trust is administered properly and complies, in all respects, with any statutory and common law obligations imposed upon it and the persons involved in its administration.

BASIC STRUCTURE OF A TRUST



We address briefly a number of the more important considerations that must be borne in mind in the course of the management and administration of a Trust.

STATUS OF THE TRUST

A Discretionary Trust. This trust is described as “discretionary” as the provisions in the trust deed entitle the trustee to exercise a broad discretion in respect of the distribution of any income and capital of the trust. With this type of trust, generally speaking, none of the beneficiaries have a specific interest in any of the trust property but do have a right to ensure that the trustee properly administers the trust.

A Fixed Trust. The trust is described as “fixed” because its provisions provide no discretion and require the trustee to distribute any income and capital of the trust in accordance with the unit holdings entitlements.

A Hybrid Trust. The trust is so described because the trustee is required to distribute any income and capital of the trust in accordance with the unit holding entitlements but may, with the authorisation of the unit holders, operate as a discretionary Trust. This type of trust potentially provides the Trustee with discretionary power and hence provides for capital protection and flexibility of distribution of income and capital. It is usual that a unanimous decision of unit holders is required to allow the Trustee to act as though the Trust is a Discretionary Trust.

A "trust" is not a legal entity itself and carries on business through the trustee. Accordingly, if the trust wishes to enter into a wide range of commercial or other transactions, it does so through and in the name of the trustee.

Please note that a Trust has a potential life span of 80 years from its establishment date and at the end of the trust period, the vesting day, the remaining assets are distributed to the beneficiaries. This may cause significant tax problems for the beneficiaries and Trustees at that time. A trust may be wound up prior to its vesting day.

POWERS OF THE TRUSTEE

The trust deed governing a trust is drafted recognising the wide range of potential commercial transactions a trustee of a modern trust may wish to embark upon. Accordingly, the trustee is given the broadest possible powers

The extent of the powers of a trustee may come under scrutiny if the trust proposes to enter into banking or financing transactions and this may require the institution to carry out an investigation of the deed.

The treatment of and definition of income for tax purposes also needs to be considered in light of the provisions of the trust deed and relevant taxation laws at the time. Classes of income are particularly important to have clearly defined in regard to distribution and taxation of income.

We are of the opinion that the powers contained in the trust document should be sufficiently broad to ensure that the trust can carry on the business proposed and enter into the widest range of transactions although, of course, should it later be found that there may be doubts regarding whether the trust has a specific power to embark upon some activity, the deed may be amended to incorporate such a power. This is a simple procedure involving preparation of a Deed Poll amending the Trust Deed.

It is generally recommended that the Trustee be a corporate entity. This is to provide additional separation between business and personal assets. If the Trust was to be sued it would be the company that would be named and hold liability unless the protagonist was able to include individual

directors or officers of the trustee company in the action. Three shareholders may also provide additional protection for actions against individuals, particularly where professional practitioners are concerned.

POWERS OF THE PRINCIPAL OR APPOINTER

The Principal or Appointer of a trust holds considerable power. The principal can change Trustees and appoint or remove beneficiaries.

You should take care in deciding who to appoint as the Principal of your trust and consideration should be given to ensuring an individual, who has high risk of being the subject of legal action, is not appointed the Principal. It could be possible that a Liquidator or Trustee at Bankruptcy could take control of the Trust if they were able to change the Trustee because they now stand in the position of the individual subject to the liquidation or bankruptcy.

TAXATION ISSUES

Historically, the popularity of discretionary trusts in Australia has emanated from pursuit of certain taxation advantages available if a trustee were to distribute the net income in any particular year of the trust in the most advantageous manner. Hybrid Trusts are becoming more popular because of the additional protection they provide for capital and the possible flexibility in distribution of income.

Our volatile tax environment and frequent amendments to the Tax Legislation have reduced many of the advantages formerly available through the use of discretionary and fixed trusts. They do remain a useful commercial vehicle providing flexibility in respect of the distribution of net income derived by the trust as well as the protection of long term assets from creditors and for estate planning purposes.

In particular, the ability to recoup losses incurred in trusts has been significantly reduced. Strict rules have been imposed in this regard and if your trust incurs losses you will need to seek professional advice to ensure access to those losses in future years is not compromised.

Where the trust derives income either from investments or from its own activities, the trustee is obliged to prepare and file a tax return in the prescribed form at the end of each financial year advising, inter alia, the net income derived by the trust.

Generally speaking, at the end of each financial year the trustee will make a determination of:

- (a) The net income of the trust; and
- (b) Those beneficiaries who shall receive the same by way of distribution if discretion is applicable. .

Net income distributed by a trustee at the end of each financial year to a beneficiary is taxable income in the hands of those beneficiaries. That must be borne in mind.

A trustee is not obliged to distribute all or any of its net income and can accumulate the same if it wishes. A penal rate of tax applies to such "undistributed income". If it does retain income it must lodge a tax return and pay tax on any net income of the trust. It may be prudent to retain a small amount of income and have the Tax Office issue an assessment each year. This limits the time period for which the Commissioner of Taxation can amend returns – the standard period being up to 4 years from the date of assessment.

Loans between associated corporate entities and Trusts can give rise to significant taxation issues under Division 7A of the Tax Act. In certain circumstances these amounts can be considered to “deemed dividends” and be treated as assessable income and no franking credits allowed to the Trustee or Trust beneficiaries.

BENEFICIARIES OF A DISCRETIONARY TRUST

The structure of the trust is to provide for three (3) classes of beneficiaries (called the “Primary”, “Secondary” and “Tertiary” beneficiaries).

Also note that provision is usually made for additional beneficiaries to be appointed. We urge you to take care if you contemplate doing so, in view of potential stamp duty and capital gains tax consequences which may arise if beneficiaries are to be added to the discretionary trust. It may be possible, under the existing Deed, to avoid any further stamp duty and capital gains tax liability in certain circumstances but you must obtain proper legal advice as the stamp duty and capital gains tax consequences can be catastrophic as trust assets accumulate.

You should be aware that whilst a trustee is under a general duty to treat all beneficiaries fairly, in the case of a discretionary trust this does not require you to distribute net income on a pro-rata basis to all potential beneficiaries of the trust. The very essence of a discretionary trust is to allow the trustee to exercise a broad discretion in how he or she distributes both net income and capital to beneficiaries.

COMMERCIAL DEALINGS OF A TRUST

The powers generally given to the trustee under the Trust Deed are extensive and we believe they are sufficiently widely drawn to cover all normal commercial dealings.

Commercial dealings of the trust will proceed in the name of the trustee. The trustee will assume personal liability in respect of all commercial dealings and transactions he enters into.

Both the terms of the trust and the provisions of the Queensland Trust Act provide the trustee with a right to indemnify him out of the net assets of the trust in respect of liabilities incurred.

Please note that if a trustee breaches the terms of the trust (by, for example, undertaking a transaction he is not empowered to), he or she will not be entitled to be indemnified out of the trust assets in respect of any personal liability assumed.

To the extent that the assets of the trust are at any time insufficient to reimburse a trustee in respect of liability he has incurred, the trustee will be personally liable.

ADMINISTRATION ISSUES

Care must be taken by the trustee in the management and administration of the trust.

If you choose to use trusts we urge you:

- On establishment to attend to opening a bank account in the name of the Trust. The first deposit to the account should be the cheque representing the settlement sum of the Trust as per the Trust Deed which establishes the validity of the Trust.

Please note that once this money is deposited into this Bank Account, it should be immediately withdrawn and retained in cash within your confidential documents. The settlement sum should remain intact at all times.

- Take care to ensure that assets of the trust (such as cash, real or personal property) are not mixed or blended with non-trust assets. Quite apart from the legal implications this can have, it can create extreme accounting difficulties when preparing the financial statements of the trust.
- Establish a minute book for the trust recording the dates and details of transactions entered into and to record minutes of the trust. In particular, such minute book should record on an annual basis the determination of the net income of the trust and its distribution. If care is taken with ensuring that a minute book is established and maintained, it should facilitate the smooth operation of the trust and ease of preparation of accounting records and tax returns.
- Ensure accurate minutes are kept of transactions entered into by the trustee. They can be typed or handwritten so long as a record is retained for future reference.

Please remember that the trust is structured to provide for a term of 80 years from establishment; although provision is made for the trustee to terminate the trust at an earlier date should it be so desired.

Upon termination of the trust, the assets of the trust at that time will be distributed to the beneficiaries in accordance with the provisions of the trust deed.

If you have queries please contact Chris Stanton-Cook at ProfitTrain.

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or

Telephone our office on 061 07 34272999

As always be safe and keep healthy and happy.

Chris

A smile is infectious - spread it around

www.cosc.com.au

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