Family trusts are great, but beware of disadvantages

The tax advantages of using a family trust are well known – in particular, the ability to split income among family members so that a lower effective tax rate applies to the income. This is unlike the case where one person derives all the income or the trust itself is liable to pay tax on it.

A family trust, like a company, is also a good way to protect assets from potential creditors in the case of financial trouble – or from other parties as the need may arise (eg, when a family member gets married and may be gifted property or money to buy a house).

So, even though a home held by a family trust is not entitled to the capital gains tax (CGT) main residence exemption, there may be other non-tax benefits that carry greater weight.

A family trust can also be used to help in business succession matters, for example, where farmland is held by a family trust where successive generations of a family can continue to farm it for their benefit.

Of course, to effectively use a family trust you need to have assets it can hold or acquire. It is of no use in trying to obtain tax advantages in respect of personal services income per se. You need for it to be able to hold assets – and preferably good income-producing assets.

However, for all their benefits there are a few demands associated with using a family trust.

For a start, if you wish to "stream" capital gains and/or franked dividends to certain beneficiaries – so that they retain their character as concessionally taxed amounts in the beneficiary's hands – then there are some complex rules that must be followed. And if they are not followed properly you can end up getting a tax result far removed from what you intended. Oh, and the trust deed must allow streaming of gains (so you may need an updated deed).

Secondly, if a trust has capital losses it cannot, unlike a partnership, distribute those losses to beneficiaries. They instead remain in the trust – and furthermore can only be used to reduce future taxable income or capital gains if certain "continuity of ownership" tests are met. And this often involves the need to make an irrevocable family trust election which locks the trust into distributing all its income to certain beneficiaries only.

Thirdly, contrary to common knowledge, distributions to children are not tax-effective in that they are usually taxed at penalty rates which equate to the top tax rate in most cases (albeit, you do get the benefit of a tax-free threshold of some $700).

Fourthly, trusts do not generally last forever (although in some state jurisdictions it is possible). At some stage the trust has to be wound up (usually after 80 years) and assets held by the trust have to be distributed to certain beneficiaries. And this can often trigger a CGT liability (and a large one at that). Just ask Gina Rhinehart and her family.

And there is also the question currently before the High Court of whether a company will be liable for Div 7A tax in respect of "unpaid present entitlements" made to it by a trust. This too is a hot issue in relation to if and how to use a family trust effectively for tax purposes.

So, the issue of whether to use a family trust is not always straightforward. Therefore, if you intend to use one, or think your current one needs some revisions, come and chat to us.