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Juggling the Complexities of Trust Distributions

The Education Network, Webinar – November 2024

Darius Hii

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Overview

- Tax and accounting income and tax effective streaming of capital gains and franked dividends
- Division 7A exposure when the trustee distribution resolution includes a company
- What records should be maintained when distributing to adult children and bucket companies
- Family trust distribution tax
- What is 'real and genuine consideration'
- Trust distributions and SBCGT concessions

- Trust distribution checklist included in the paper

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Managing the mismatch between tax and accounting income and ensuring tax effective streaming of capital gains and franked dividends

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Key legislative provision

"(1)…where a beneficiary of a trust estate who is not under a legal disability is presently entitled to a share of the income of the trust…the assessable income of the beneficiary shall include:

(a) the assessable income of the beneficiary shall include:

> *(i) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident"*

- Section 97 ITAA 1936

In plain English

- Such share of the 'income of the trust' to which a beneficiary is entitled to received – **Distributable Income** (income that can be distributed from the trust)
- The beneficiary is taxed on such share of the 'net income of the trust estate' that is attributable to such a beneficiary – **Net Tax Income** (the assessable or taxable income)

Issues arising

- Discrepancy between Distributable Income and Net Tax Income
  - Deductions that are not taxable
  - Capital gains made

- E.g.
  - Income available to distribute (after expenses) - $66,000
  - Taxwise, $34,000 of the expenses were not deductible, so there was $100,000 of 'assessable income'
  - Income was split 50/50 between persons A and B
  - Person A and Person B each received $33,000
  - Does Person A and Person B pay tax on the $33,000 received?
  - Does Person A and Person B pay tax on $50,000 allocated to them? (as the assessable income of the beneficiary shall include so much of that **share** of the net income of the trust estate as is **attributable to…**the beneficiary)

Bamford

- Correct approach to adopt is the **proportionate** approach
- Ended a long running debate
- But there were other queries:
  - A capital gain was made in a later year
  - Sought to distribute capital gain as income beneficiaries
  - Commissioner argued that capital gain could not be distributed as capital gains were not ordinarily considered as 'income' (and thus were taxed at the top marginal rate per section 99A ITAA 1936)
  - Taxpayer argued that the capital gain could be distributed as income as there was a power in the trust deed to allow the trustee to include a capital gain as income for distribution (i.e. Distributable Income)
  - Held that Distributable Income was determined in accordance with the terms of the trust deed, general trust law and appropriate accounting principles

Bamford

- Key take-aways
  - Tax flows in proportion to how Distributable Income split
  - Distributable Income is whatever the trust deed allows it to be
- They do not always align
- Line of thinking developed to match Distributable Income with Net Tax Income
- No right or wrong as different beliefs allow for issues to consider

Distributable Income as anything?

- Distributable Income can't be everything
- Although accepts the principle through a Decision Impact Statement
- Draft Tax Ruling TR 2012/D1 outlines ATO's position on what constitutes 'income of the trust estate'
- Importantly, TR 2012/D1 argues that notional amounts (such as franking credit gross up, deemed capital gains etc…) cannot be considered as income
  - Income requires an accretion

Streaming

- *Bamford* suggested that streaming was not possible – as tax flowed in proportion to distribution, meaning even classifying separate classes would have such distributions flowed in proportion between beneficiaries
- Interim streaming provisions introduced allowing streaming of:
  - Capital gains
  - Franked distributions
- Allowed trustee to separate 'stream' (distribute) such capital gain or franked distributions to other beneficiaries (or in different proportions):
  - Useful if certain persons held capital losses
  - Useful if distributing to other corporate entities

Specifically entitled

- Beneficiaries to be made 'specifically entitled' to such capital gains or franked distributions being streamed
- I.e. beneficiaries must receive or reasonably be expected to receive an amount equal to the 'net financial benefit' linked to the capital gain or franked distribution
- Other steps also taken:
  - Separately record character of such amount in records of the trust
  - Complementing resolutions, accounts, ledgers and financial statements

Many faces of Distributable Income

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- Distributable Income means income according to ordinary concepts
- Distributable Income means section 95 (or Net Tax Income) less notional amounts
- Distributable Income means such amount which the trustee determines
- Each meaning impacts whether certain 'income/gains' are included
- Practically, consider capital gains:
  - Ordinary concepts does not equal capital gains
  - Section 95 income only includes assessable capital gain (not any discounted amount)
  - Such amount the trustee determines can include capital gains if the trustee makes an active determination

Capital gains specific entitlement

- Assume:
  - $100,000 rental income
  - $1,000,000 capital gain
- Proposed distribution:
  - Rental income to Husband and Wife
  - Capital to Dad (who has made massive capital losses during his lifetime)
- Depending on what the definition of Distributable Income, different resolutions are required:
  - Equals ordinary income – a capital distribution would need to be made to ensure Dad is specifically entitled to the capital gain
  - Equals section 95 income – an income distribution relating to 50% of the capital gain needs to be made in conjunction with 50% of the capital gain via a capital distribution
  - Equals such amount the trustee determines – trustee has flexibility

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Managing Division 7A exposure when the trustee distribution resolution includes a company

TD 2022/11

- On or before 30 June 2022 – PSLA 2010/4 and TR 2010/3
- From 30 June 2023 onwards – TD 2022/1
- Distinction under TD 2022/11 on what constitutes 'financial accommodation'
- Changed given that the same individuals often control the trustee of the distributing trust and the private company beneficiary

What financial accommodation?

- Corporate Initiatives Pty Ltd v Commissioner Of Taxation [2005] FCAFC 62 noting that:

[72] The Full Federal Court also concluded that, by not calling for payment of funds distributed to it, the private company beneficiary with knowledge of the UPE provided a benefit to the trustee who could continue to use the trust funds for trust purposes, and stated that (emphasis added):

> *We therefore think the Tribunal was correct in proceeding on the basis that,* ***on demand being made by SBS as trustee for CUT, Eldersmede would have to do something to arrange funds for the payment, whether by selling, or borrowing against, available assets, which would then no longer be available for other trust purposes. Not having to do this was a benefit. Eldersmede was thus in a better or more favourable position than it would have been had it been required to fund the distributions.***

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When financially accommodating

- At the date of the resolution or some other date?
- Only when the UPE amount will be able to be calculated with sufficient certainty (commonly after the end of the income year)
- Accordingly at [102]:
  - *'[i]f a complying loan agreement is entered into in respect of the financial accommodation, the first minimum yearly repayment will be due by 30 June of the year following the income year in which the financial accommodation was provided.'*

When in compliance

30/6/2023	Private company beneficiary becomes presently entitled to 100% of trust income.
1/8/2023*	The income of the trust is determined. The private company beneficiary provides financial accommodation to the trustee.
15/5/2025**	The private company beneficiary and the trustee enter into a complying loan agreement in respect of the financial accommodation before this date.
30/6/2025	The first minimum yearly repayment under the complying loan agreement is due by this date.

*Date may be different depending on when the income of the trust is determined for the 2022-23 income year.

**Date may be different depending on the lodgment day of the private company beneficiary's tax return for the 2023-24 income year.

What records should be maintained to support tax effective distributions to adult children and bucket companies

Section 100A

- Beneficiary has a present entitlement
- Present entitlement arose under a reimbursement agreement
- Benefit is provided to someone other than the beneficiary
- Agreement is not entered into in the course of ordinary family or commercial dealing
- Entered into for a purpose of reducing income tax

- May apply when distributing to adult children (potentially lower tax rates) and bucket companies (30% flat tax rate)

Section 100A – The basic example

- Low Income Adult Child has present entitlement to trust income
- Money never distributed to Low Income Adult Child but rather trust lends to High Income Parent
- Low Income Adult Child either gifts, forgives or assigns amount at a later date
- Okay/Not okay?

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ATO Guidance

- TR 2022/4 – Income tax: section 100A reimbursement agreements
- PCG 2022/2 – Section 100A reimbursement agreements: ATO compliance approach
- TA 2022/1 – Parents benefitting from trust entitlement of their children over 18 years of age

- The above outlines the ATO position on what is 'ordinary family or commercial dealing'

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TR 2022/4 comments

- Paragraph 98:
  - Acknowledges test involves an inquiry into the objectives of the dealing and whether steps comprising of the dealing would achieve the objective. Can the dealing or steps be explained by different objectives to those said to be behind the ordinary family or commercial dealing
  - Ruling provides example of *Guardian* and *Bblood*
- Paragraphs 110 to 113:
  - Acknowledges that cultural factors may inform question on what is an 'ordinary family dealing' depending on cultural practices of a family group.
    - *'grandparents [to gift]…money or goods to younger members of the family'*
    - *'for religious reasons will not accept the entitlement'*
    - *'children will meet the needs for shelter and living of their parents and other older relatives when they are no longer participating in the workforce'*

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TR 2022/4 comments

- Example 8 outlines various factors that may impact trust distributions from a parent's trust to an adult child to assist with the purchase of a home:
  - *"If the arrangements were to involve parents gifting money received from a trust to their children repeatedly and one or more of the following factors are present*
    - *the parents have a lower marginal tax rate*
    - *the parents have lesser financial means than the adult child, or*
    - *the adult child is also capable of benefitting under that trust in their own right; for example, the parents may be subject to lower tax rates because they are retired and in pension phase or have significant losses to reduce tax payable on trust distributions.*
  - *Arrangements where the situation is reversed, so that Alex (who has limited financial resources apart from a distribution made to her and has a lower marginal tax rate) gifts money to her parents Lisa and Jessie who are subject to higher rates of tax, and there is no financial or cultural circumstance that would explain the gift.*
  - *Arrangements where Alex, who has a lower marginal tax rate, agrees to apply her trust entitlements to reimburse her parents for costs incurred by them on her maintenance, education and financial support while Alex was a minor."*

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PCG 2022/4 comments

- Cumbersome to apply an analysis for every trust within the firm, hence PCG **guidelines**
- Regarding distributions to adult children, note the Red Zone which involves an adult beneficiary in receipt of a trust distribution making gifts or loans to another party where such:
  - *distribution is paid to the parent or caregiver of the beneficiary in connection with expenses incurred before the beneficiary turned 18 years of age;*
  - *distribution is applied by the trustee of the trust against a debit balance account for the beneficiary representing expenses incurred by the trustee in respect of the beneficiary before they turned 18 years of age; or*
  - *adult beneficiary is a non-resident relative of the resident controller of the trust and the distribution is made available to a resident taxpayer by way of loan or gift.*

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PCG 2022/4 comments

- Regarding distributions to a company beneficiary, scenario 3B notes a Green Zone scenario where:
  - there is a retention of funds;
  - the company is a member of the same family;
  - the retained funds are used for the working capital of a business that the trust actively carries on; or are used to acquire, maintain or improve investment assets of the trust
  - a complying Division 7A loan agreement is entered into
  - no exclusions apply

TA 2022/1

- The Taxpayer Alert outlines the scenarios in which the ATO will consider parents as benefiting from trust distributions made to adult children.
- Includes example of adult children receiving $160,000 from trust distributions without being paid the entitlement (the amount instead being used to offset the parent's mortgage account).
- Distinguishes between the following examples:
  - Risky example – where adult child presently entitled to $160,000 but such amount is paid to the father for repayment of expenses incurred whilst adult child was a minor.
  - 'Ordinary dealing' example – where adult child presently entitled to $40,000 and a proportion of such amount is paid to relatives who have either incurred expenses on behalf of the adult child (whilst an adult) or is owed to the relative (for board)

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Evidence – company beneficiary

- Complying Division 7A loan agreement
- Evidence proving use of retained funds in working capital for the trust (resolutions, notes or records of discussions or meetings)
- Appropriate accounting records
- Evidencing future dividends declared are sourced separate from the trust distribution

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Evidence – adult beneficiary

- Appropriate steps to ensure trust resolutions are prepared pursuant and in compliance with the terms of the trust deed.
- Ensuring each beneficiary recipient is advised of their entitlements in writing.
- Ensuring the accounts of the trust properly reflect the treatment of such entitlement.
- Where a beneficiary wishes to apply their entitlement in a certain manner (whether by way of gift or loan), steps should be taken that appropriate written documentation are drawn and executed to confirm how such entitlement is to be dealt with.

How family trust distribution tax is being inadvertently triggered

What is it

- Applies when a family trust election made
- Top marginal rate
- Trigger if trust confers a present entitlement or distributes income or capital to someone outside the family group
- Individual trustee liable
- Company trustee liable along with each person who was a director of the company at the time of distribution (all jointly and severally)

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Family group

- Test individual
- Spouse
- Parent and grandparent of the test individual and spouse
- Lineal descendants of test individual and spouse
- Siblings of test individual and spouse
- Lineal descendants of siblings of test individual and spouse
- The trust that made the FTE
- Trusts with FTE with same test individual
- Companies, partnerships, trusts with interposed entity elections
- Companies, partnerships, trusts in which family group members have fixed entitlements directly or indirectly to all of the income and capital

Distributes

- Broader than the concept of income/capital distribution
- Includes:
  - Paying (including by way of a loan) or credits money to a person or reinvests much for a person.
  - Transferring property to an entity or allowing the use of property of the entity to a person.
  - Extinguishing, forgiving, releasing or waiving a debt or other liability owed by a person.
  - The buy-back of share capital.

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Buyer beware

- ATO ID 2004/162 – Family Trust Distribution Tax can apply to a redemption of units where the amount paid exceeded the value of any consideration given in return.
- Transfer of shares by family trust for less than market value to an entity outside the family group.
- Dividends declared by a company (which has made an interposed entity election) to a newly introduced shareholder (outside the family group).
- Transfer of business assets out of a company (which has made an interposed entity election) to an unrelated entity (outside the family group).

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Tips to ensure "real and genuine" consideration has been given to all potential beneficiaries and the tax consequences if it hasn't.

Real and genuine consideration

- Trustee's discretion generally cannot be challenged
- Method of how a trustee's decision is made *could* be challenged where not in good faith
- 'Bad faith':
  - where a trustee fails to consider the intention of the trust's creator/settlor prior to making a decision
  - where a trustee is deliberately deceptive for their personal gain or decisions are exercised with dishonesty
  - where a trustee fails to give real and genuine consideration to the exercise of their discretions
- Ying Mui & Ors v Frank Kiang Ngan Hoh & Ors (No 6) [2017] VSC 730
- Callus v KB Investments [2020] VCC 135

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Owies v JJE Nominees Pty Ltd

- John and Eva (the parents and deceased)
- Michael, Deborah and Paul (the children)
- Mr Sampson (the solicitor)
- JJE Nominees Pty Ltd (the trustee) of which John and Eva held the two issued shares and where directors until their deaths in 2020 and 2018 respectively
- Noted Mr Sampson purportedly was appointed as a director in December 2017 (that was held to be invalid), before being validly appointed from 10 March 2020
- Michael was also appointed a director from 2019

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Owies v JJE Nominees Pty Ltd

- Trust assets valued at $23m
- Annual income in the $000,000
- Primary beneficiaries were John, Eva, Michael, Deborah and Paul
- Standard trust deed with default beneficiaries being Michael, Deborah and Paul
- Distributions from 2011 to 2018 were split between John (40%), Michael (40%) and Eva (20%)
- After Eva's death in 2019, Deborah threatened a family provision claim against Eva's death before receiving a capital distribution from the trust of a residential unit in South Yarra (~$750,000) that she had been living in since 1984

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Owies v JJE Nominees Pty Ltd

- On and off relationship issues between John/Eva and Deborah/Paul
- Disgruntled children would have years of estrangement with their parents before reconnecting
- Noted Deborah had multiple medical conditions resulting in her inability to work full-time for extended periods
- Noted Paul made a request for a copy of the trust deed and enquiries about the trust's assets which went unanswered
- Deborah and Paul sought to challenge the following for the period between 2010 and 2019 (among other issues):
  - Numerous variations which had been made to the trust deed
  - Whether distributions of income had been made
  - That the trustee failed to give real and genuine consideration to the objects of the trust

Owies v JJE Nominees Pty Ltd

- 11 grounds summarised into 3 issues:
  - Claimed trustee did not give real and genuine consideration to Paul and Deborah's positions in 2017 to 2019 based on the fact the trustee had sufficient information when making the decisions (noting a payment of approximately $1,000,000 to John in 2019 as 'grotesque' given that John was 96 and in full-time care)
  - Appropriate relief for the failure to exercise real and genuine consideration of a potential beneficiary is for the distribution to be set aside on it being void or invalid
  - The trustee should also be removed

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Owies v JJE Nominees Pty Ltd

- Noted trustee made no direct enquiries of Paul or Deborah before making any distributions (evidenced through lack of, or minimal contact between parties)
- Noted bizarre distributions to John and Eva who had no obvious need for the distributions as opposed to Paul and Deborah
- Noted there was a lack of an exercise of an independent mind to the trustee decisions and the interests of John and Eva did not correspond with the best interests of the beneficiaries
- Patterned nature of distributions criticised as trustee reached a 'policy of distributions with a settled ration that was inconsistent with a continuing obligation to consider the distribution of income for each accounting period'.
- Also, by not explaining reasons for distributions, it left a 'stark pattern of distributions to speak for itself' in determining that no reasonable person would have made the same decisions as those of the trustee
- Focus on 2019 distribution distributing 100% to John

Owies v JJE Nominees Pty Ltd

- Takeaways:
  - Wording of the trust deed matters
  - Naming of primary beneficiaries can make a difference
  - Not an automatic 'tick'
  - Care and thought of key beneficiaries of the trust crucial
- Other things to note:
  - Breach of fiduciary duty means distributions may be voidable but not void (i.e. needs to be requested as part of dispute)
  - Trustee was removed as they failed to act impartially
- Tax implications of voided distribution may require amended returns

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How trust distributions today can impact on entitlement to the small business capital gains tax (CGT) concessions in the future.

Trust distributions and SBCGT Concessions

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- Connected with for the purposes of the MNAV or Turnover Test
  - Connected with definition considers historical distributions
  - Considers both income **or** capital distribution
  - Distributing without consideration a few years before a sale may result in additional entities being connected with the taxpayer (and potentially affect the ability to fall within the relevant thresholds)

Trust distributions and SBCGT Concessions

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- Ability to have a significant individual
  - Met where an individual has a small business participation percentage of at least 20%
  - Small business participation percentage in a discretionary trust is the percentage of distributions to the income and capital in a year, '**or, if 2 different percentages are applicable, the smaller**'.
  - Issue if making separate income and capital distributions to different persons, e.g. persons A and B are made presently entitled to income, whilst person C is made presently entitled to the capital in an income year (as a result of seeking to stream capital gains to a person holding capital losses)
  - Issue may also arise where the terms of the trust deed cause a discrepancy in the definition of distributable income for the trust and capital
    - ATO ID 2012/99 acknowledging that '*references to distributions of 'income' in the context of determining an entity's direct small business participation percentage in a trust mean the income of the trust, determined according to the general law of trusts, to which a beneficiary could be entitled. Depending on the deed and/or actions of the trustee, this may be an amount that differs from the ordinary income of the trust*'

Questions?

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