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# **Navigating the Annual Trust Tax Traps: Clearing the Key Hurdles**

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**Darius Hii, Director, CTA**  
**Chat Legal Pty Ltd**



Chat Legal Pty Ltd  
ABN 64 621 391 553  
[letschat@chatlegal.com.au](mailto:letschat@chatlegal.com.au)  
PO Box 74, Underwood, QLD 4119  
<https://chatlegal.com.au>

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## Navigating the Annual Trust Tax Traps: Clearing the Key Hurdles

### 1 Overview

- 1.1 Managing the annual tax compliance obligations of a discretionary trust can feel like an obstacle course.
- 1.2 With ever evolving developments through Australian Taxation Office (**ATO**) guidance and Court/Tribunal decisions, the list of potential traps continue to grow.
- 1.3 This paper will seek to provide a detailed breakdown of the most common hurdles that a practitioner may face when making a trust distribution, including:
  - (a) Ensuring the trust deed is reviewed for problematic distribution clauses that may relate to:
    - (i) the definition of income; and
    - (ii) when beneficiaries include non-residents.
  - (b) Tax consequences if the trust deed can't be located and steps that may be taken to minimise the damage.
  - (c) The potential risk for disputes where the trustee fails to give "real and genuine consideration" when applying discretion to the annual distribution of trust income.
  - (d) Navigating trust specific tax legislation such as:
    - (i) section 100A *Income Tax Assessment Act 1936* (**ITAA 1936**);
    - (ii) the impact of Commissioner of Taxation v Bendel [2025] FCAFC 15 (**Bendel**) on unpaid present entitlements to companies and the impact of Subdivision EA ITAA 1936; and
    - (iii) the claiming of trust losses.
  - (e) Family trust elections and interposed entity election issues that may arise in practice.
  - (f) The application of the General Anti-avoidance Part IVA provisions and its application when a discretionary trust is involved.
  - (g) The application and implications of section 99A ITAA 1936 applying.
- 1.4 A brief review of the various amendment time limits specific to trust issues will be noted during the presentation.
- 1.5 A reference to **ITAA 1997** in this paper is a reference to *Income Tax Assessment Act 1997* (Cth).



## 2 Trust deeds and problematic distribution clauses

### *The importance of the definition of 'income'*

2.1 Critical in ensuring effective trust distributions is an understanding on:

- (a) what can be distributed from the trust; and
- (b) how are such distributed amounts taxed (particularly where there is a mismatch between tax and accounting income)?

#### ***Net income and distributable income (otherwise known as trust income and occasionally as accounting income)***

2.2 Both questions are answered (on their face) under section 97 ITAA 1936:

*"(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"*

2.3 From section 97 ITAA 1936, a formula arises whereby:

- (a) Such share of the 'income of the trust' to which a beneficiary is entitled to receive is calculated (which we will call **Distributable Income** but can also be known as **Trust Income** and is commonly referred to as 'accounting income' in trust deeds).
- (b) The beneficiary is taxed on such share of the 'net income of the trust estate' that is attributable to such a beneficiary (which we will define as **Net Tax Income** but is also known as 'section 95' income).

2.4 As to the meaning of 'income of the trust' estate and 'net income of the trust estate', the High Court case of *Bamford*<sup>1</sup> established that:

- (a) The phrase 'income of the trust estate' in section 97 ITAA 1936 means trust income as determined in accordance with trust law principles (being Distributable Income).
- (b) The 'share' of 'net income of the trust estate' (being the taxable income derived by the trust known as Net Tax Income) assessed to a beneficiary under section 97 ITAA 1936 is the beneficiary's proportionate share of Trust Income, rather than any approach based on the quantum of Trust Income received by the beneficiary.

2.5 The facts of *Bamford* relates to the taxation of trust distributions made in two income years.

#### ***2000 income year***

- (a) In the 2000 income year the trustee resolved to distribute \$34,000 each to Mr and Mrs Bamford with the balance of Trust Income to the Church of Scientology.
- (b) It was subsequently discovered that certain deductions claimed by the trust were not allowable under the tax law which resulted in Net Tax Income of the trust to exceed its Distributable Income.
- (c) The question was how this excess should be taxed under section 97 ITAA 1936.

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<sup>1</sup> *Commissioner of Taxation v Phillip Bamford & Ors* [2010] HCA 10



- (d) The taxpayer argued that they should only be taxed on the amount of Distributable Income actually distributed to them.
- (e) In contrast, the Commissioner of Taxation's (**Commissioner**) approach was to include in Mr and Mrs Bamford's assessable income, such proportion of Net Tax Income derived by the trust which was referable to the proportion in which Trust Income had been distributed Mr and Mrs Bamford (known as the proportionate approach).

**2002 income year**

- (f) In the 2002 income year the only taxable income derived by the trust was a net capital gain.
- (g) Apart from the net capital gain, the trust derived no other Distributable Income.
- (h) The Distributable Income was not defined in the trust deed but included a provision which allowed the trustee to include a capital gain in Distributable Income.
- (i) Using this power, the trustee resolved to distribute the net capital gain to beneficiaries.
- (j) The Commissioner sought to argue that that the concept of Distributable Income was fixed to ordinary concepts and could not include a capital gain.
- (k) As such, the Commissioner sought to assess the trustee on the capital gain at the top marginal tax rate under section 99A ITAA 1936

2.6 As to the question relating to how the beneficiaries should be taxed on the Distributable Income received, the High Court clarified that the proportionate approach adopted by the Commissioner was the correct approach to adopt in determining a beneficiary's share of Net Tax Income of a trust. In determining this issue, the High Court ended a long running debate as to whether a proportionate or quantum approach to determining a beneficiary's share of Net Tax Income was correct.<sup>2</sup>

2.7 As to the question on whether the concept of Distributable Income was fixed to ordinary concepts, the High Court determined that the concept of Distributable Income (or Trust Income) takes its meaning from trust law. Distributable Income was therefore determined in accordance with the terms of the trust deed, general trust law and appropriate accounting principles. As a result, the High Court ruled that the Commissioner was wrong to tax the capital gain made by the trust in the 2002 income year under section 99A ITAA 1936. Since the trust deed conferred on the trustee the power to include a capital gain in Trust Income and this had been validly exercised by the trustee, the High Court ruled that the net capital gain should be assessed to the beneficiaries to whom distributions of Trust Income had been made.

2.8 Following the *Bamford* decision, the ATO issued a Decision Impact Statement which is summarised as follows:

- (a) The concepts of Distributable Income and Net Tax Income are two different subject matters which do not necessarily correspond.
- (b) In subsection 97(1) of the ITAA 1936, 'income of the trust estate' (i.e. Distributable Income) takes its meaning from the general law of trusts and not from taxation law.

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<sup>2</sup> See discussions in *Davis v FCT* 89 ATC 4377, *Richardson v FCT* 89 ATC 5098 and *Zetaforce v FCT* 98 ATC 4681



- (c) Under the general law of trusts the concept of 'income' is governed by a set of rules designed to ensure that trustees fairly apportion the receipts and outgoings of a period between those entitled to income and those with an interest in capital.
- (d) Under trust law, there are presumptions about whether particular receipts or outgoings constitute income or capital of the trust but these presumptions can be displaced by express provision in the trust deed.
- (e) The 'proportionate approach' applies in determining a beneficiary's share of the trust's Net Tax Income.
- (f) The proportionate approach is a mathematical calculation based on applying the percentage share that a beneficiary is presently entitled to Distributable Income, to the trust's Net Tax Income.

### ***Streaming of capital gains and franked distributions***

- 2.9 The outcome of *Bamford* did force a change in law regarding the taxation of trusts.
- 2.10 Prior to the case, it was largely considered standard practice that trustees of trusts could stream provided the terms of the trust deed allowed for it.
- 2.11 The Commissioner, however, adopted a more stringent position on the proportionate approach, arguing that streaming was not possible on the basis that a beneficiary's percentage of total Distributable Income they were presently entitled to, meant that the Net Tax Income flowed in the same proportion. Such approach did not cater for separate classes of income being set aside and dealt with separately. Rather, beneficiaries were deemed to have received a portion from each different class of income based on their percentage over the total Distributable Income.
- 2.12 Given the ambiguity, the Government introduced streaming provisions in *Taxation Laws Amendment (2011 Measures No. 5) Act 2011 (TLAM5)*. It should be noted that such measures were only intended to operate in the interim until a review of the taxation of trust could be finalised and a rewrite of the rules were undertaken. Unfortunately, as of the date of this paper, no rewrite has occurred and as such the interim measures of TLAM5 are still of effect.
- 2.13 The effect of TLAM5 can be summarised as follows:
  - (a) All capital gains and franked distributions are now assessed to a beneficiary under Subdivision 115-C and Subdivision 207-B Income Tax Assessment Act 1997 (Tax Act 1997) respectively.
  - (b) No other classes of income (such as interest income) are specifically included as being able to be streamed as a separate class of income under TLAM5.<sup>3</sup>
  - (c) If a trustee wishes to stream capital gains or franked distributions to specific beneficiaries, the process under the TLAM5 amendments is:
    - (i) Start with Division 6 ITAA 1936 – determine each beneficiary's share of the 'income of the trust estate';
    - (ii) Determine amounts of capital gains and franked distributions to which beneficiaries are **specifically entitled** – see below how a specific entitlement

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<sup>3</sup> Subsequent to the enactment of the TLAM5 amendments, the Full Federal Court in *FCT v Greenhatch* [2012] FCAFC 84 endorsed the Commissioner's mathematical approach to applying the proportionate approach. This suggests that outside of the TLAM5 streaming amendments it is not possible to stream other types of trust income differentially as between beneficiaries.



- arises - and each beneficiary's 'adjusted Division 6 percentage' of the remaining 'income of the trust estate';
- (iii) Apply the Subdivisions 115-C and 207-B Tax Act 1997 to assess the beneficiaries (or trustee) on their share of capital gain made or franked distributions derived by the trustee; and
  - (iv) Apply Division 6E ITAA 1936 to adjust the taxable income amounts otherwise assessed to a beneficiary (or trustee) under Division 6 ITAA 1936.
- (d) Capital gain and franked distributions to which no beneficiary is specifically entitled to will be allocated proportionately to beneficiaries using the adjusted Division 6 percentage - being their present entitlement to 'income of the trust estate' excluding capital gains and franked distributions which any entity is specifically entitled to.
- (e) The balance of the 'income of the trust estate' (after deducting all capital gains and franked distributions), appointed to beneficiaries is assessed under Division 6 but using the adjusted Division 6 percentage. Double taxation is avoided by Division 6E ITAA 1936 eliminating capital gains and franked distributions from Division 6 ITAA 1936.
- 2.14 A crucial aspect in being able to stream capital gains and franked distributions is the need to ensure target beneficiaries are made '**specifically entitled**' to such capital gains or franked distributions.
- 2.15 In order for beneficiaries to be considered **specifically entitled**, 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 in the trust.
- 2.16 Further, the beneficiary's entitlement to the amount must be recorded in its character in the accounts or records of the trust. In addition to needing to have resolutions drafted appropriately; accounts, ledgers and financial statements are required to be consistent with this.
- 2.17 Before considering the impact of such streaming provisions to such Distributable Income of a trust, it is important to appreciate that issues can arise when seeking to link '*net financial benefits*' to the relevant beneficiaries. Such issues can include (but are not limited to):

***Relating to capital gains streaming***

- (a) Ensuring that capital gains revalued as a result of an asset revaluation reserve are tracked over the life of the asset to the target beneficiary.
- (b) Contracts that fall over two income years may result in a capital gain being linked in the prior income year, but will require additional tracking upon the asset settling in the later income year.
- (c) Where a capital gain has been made, but the definition of income of a trust deed causes there to be no Distributable Income (perhaps, for example, due to the definition of income being linked to the ordinary concepts of income which would not ordinarily include capital gains), then steps must be made to ensure such target beneficiaries are made specifically entitled.

***Relating to franked distribution streaming***

- (d) Where a franked distribution is fully offset by losses or relevant expenses, then there will be difficulty in making beneficiaries specifically entitled to such franked

distributions. This can often be managed by pooling all franked distributions into a single class of income, thus leaving some net franked distribution for distributing.

- (e) Franking credits are not able to be separately streamed as mentioned in paragraph 2.60 of the explanatory memorandum introducing TLAM5.

2.18 Much of the above issues may arise where no Distributable Income exists that enables beneficiaries to be specifically entitled to capital gains or franked distributions (due to no excess amount that can be distributed to such beneficiaries).

***The importance in understanding what is Distributable Income***

2.19 Back to our initial question in knowing what can be distributed from the income.

2.20 Understanding what Distributable Income of a trust for an income year is crucial as the tax flows in proportion to such amounts (subject to any streaming of capital gains or franked distributions). Further, Distributable Income is an important concept in ensuring beneficiaries can be made specifically entitled, to allow for the streaming of capital gains or franked distributions.

2.21 As held in *Bamford*, the terms of a trust deed determine what Distributable Income is.

2.22 There are limits, however, as issued by the Commissioner in Draft Taxation Ruling TR 2012/D1 on what can constitute 'income of the trust estate' (i.e. Distributable Income).

2.23 Specifically, income must be tangible and cannot include notional amounts such as the franking credit gross up, amounts included in assessable under the accrual provisions of transferor trust rules and controlled foreign companies rules, and deemed capital gains arising from the application of the deemed market value capital proceeds rule.

2.24 Trust deeds themselves commonly define Distributable Income into one of three categories:

- (a) Distributable Income means income according to ordinary concepts.
- (b) Distributable Income means section 95 income (or Net Tax Income) less notional amounts.
- (c) Distributable Income means such amount which the trustee determines.

2.25 Where Distributable Income is defined to mean income according to ordinary concepts, then care should be taken when capital gains have been made. In such circumstances, Distributable Income would not include capital gains as being able to be distributed under an income power, and steps would need to be taken to ensure beneficiaries are made specifically entitled through a separate distribution of capital.

2.26 Where Distributable Income is defined to mean section 95 income, then only part of a capital gain would be included where the 50% CGT discount applies. Part of the capital gain would still be sheltered and if streaming is required, a separate distribution of capital would be required in tandem with an appropriately drafted classification of the taxable capital gain as a separate income class. In extension, where the small business capital gains tax concessions are being applied, parts of such capital gain made on the same of such business assets will also be sheltered and not be considered 'section 95 income'.



- 2.27 Where Distributable Income means such amount which the trustee determines, then flexibility is offered to trustees to determine the manner in which they wish to define Distributable Income, provided it is within reason.<sup>4</sup>
- 2.28 Given the benefits in being able to determine income in a wide range of manners, trust deeds should ideally (but not always) contain additional powers for the trustee to: be able to recharacterise receipts and outgoings as income or capital, account for and deal with separate classes of income and determine whether or not to offset prior year trust losses against current year income.
- 2.29 The importance of a trustee having the ability to determine whether or not to offset prior year trust losses is highlighted due to the traditional rule in *Upton v Brown (1879)* 12 Ch D 872 that prior year losses must be recouped against current year Distributable Income. This power can be useful where there is a disparity between trust losses and tax losses – for instance, a trust fails the trust loss tests and so cannot claim the benefit of prior year losses. If the rule in *Upton v Brown* is not displaced in this situation, it is possible to have a section 99A situation where trust losses reduce Trust Income to nil but there is still positive Net Taxable Income for the trust.

### ***Foreign beneficiary exclusion clauses***

- 2.30 Separate to the various withholding requirements that are imposed when trust distributions are made to a non-resident beneficiary, consideration must be made whether a trust can distribute to such non-resident beneficiary.
- 2.1 It is common for trusts seeking to acquire property to specifically exclude distributions to any 'foreign persons'.
- 2.2 This has been a result of the enforcing of the *Foreign Acquisitions and Takeovers Act 1975* (Cth) (**FATA**).
- 2.3 Generally, if FATA is applicable to an investor, they are required to seek government approval of the investment. This screening and approval process are undertaken by the Foreign Investment Review Board (or more commonly referred to as FIRB).
- 2.4 While this paper is not intended to focus on FIRB and FATA, it is worthwhile understanding how FATA defines a foreign trust, as the approach adopted under this legislation can be found in other State tax legislations across the country (such as New South Wales subject to a minor modification).
- 2.5 Further (and as mentioned above), foreigners who acquire certain assets exceeding regulated thresholds, are required to apply for approval prior to acquisition. This process will cost time, but also an application fee will be payable.
- 2.6 For FIRB application purposes, a foreign person is defined in section 4 of FATA to include:
- (a) *'The trustee of a trust in which an individual not ordinarily resident in Australia, a foreign corporation or a foreign government holds a substantial interest';* and

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<sup>4</sup> A blatant recharacterisation of income to capital is likely to fall foul of the general anti-avoidance provisions of Part IVA Tax Act 1936. In *Forrest v FCT* 2010 ATC 20-163 the Full Federal Court ruled that a trustee could not exercise a broad power to recharacterise receipts and outgoings as income or capital without regard to the terms of the trust. In that case the trust was a hybrid trust with unitholders holding a fixed entitlement to trust income and discretionary beneficiaries who were potentially entitled to distributions of capital gain.





- (b) *'The trustee of a trust in which 2 or more persons, each of whom is an individual not ordinarily resident in Australia, a foreign corporation or a foreign government, hold an aggregate substantial interest'.*
- 2.7 Substantial interest is defined to mean at least a 20% interest in an entity, while aggregate substantial interest is defined to mean at least a 40% interest in an entity.
- 2.8 Therefore, if a trust has:
  - (a) a 'foreigner' with a 20% interest in the trust; or
  - (b) multiple 'foreigners' with a 40% interest in the trust,the trust will be a foreign person and potentially required to obtain approval for any investments into Australia.
- 2.9 While exact percentages can be identifiable when trusts have fixed interests, discretionary trusts provide the trustee with the flexibility in deciding the income and capital distributions on an annual basis.
- 2.10 Section 18(3) of FATA, therefore provides a deeming rule where every beneficiary is taken to hold the maximum percentage of income or capital of the trust they could receive.<sup>5</sup> In other words, if there is no restriction on how much income or capital can be distributed to a beneficiary, then each beneficiary is deemed to hold a 100% beneficial interest in the trust.
- 2.11 Therefore, to ensure foreign persons cannot be deemed to hold a 100% beneficial interest in a discretionary trust, blanket bans on distributions to foreign persons are commonly included.
- 2.12 Where distributions are made from a discretionary trust to another trust, then care will need to be taken to ensure the receiving trust includes appropriate provisions to ensure it is not considered a foreign person.

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<sup>5</sup> 'For the purposes of this Act, if, under the terms of a trust, a trustee has a power or discretion to distribute the income or property of the trust to one or more beneficiaries, each beneficiary is taken to hold a beneficial interest in the maximum percentage of income or property of the trust that the trustee may distribute to that beneficiary.' – Section 18 of FATA.



### 3 Lost trust deeds and steps to minimise the damage

- 3.1 In light of the importance in reviewing the terms of a trust deed for both the ability to distribute income, as well as confirming who is in fact a beneficiary; it goes without saying that it is paramount that the original trust deed can be found.
- 3.2 Failure to hold a fully executed copy of the original trust deed may result in various important questions being left unanswered relating to the distribution of income each financial, such as (but not limited to):
- (a) Who can benefit from the trust?
  - (b) Does the trust allow for discretionary distributions to certain beneficiaries in certain proportions?
  - (c) What can be distributed from the trust?
  - (d) Can the trust stream income?
  - (e) Does the trust allow for the carry forward of trust losses?
- 3.3 Most crucially, where the terms of a trust cannot be located, there is a real risk that the trust may fail for uncertainty.
- 3.4 The case of *Mantovani v Vanta Pty Ltd (No 2)* [2021] VSC 771 considered this question and in light of the trust in that case failing due to uncertainty; it was held that a resulting trust arose in favour of the settlor of the original trust.
- 3.5 In that case, only the Schedule of the original deed was locatable.
- 3.6 Fortunately for the beneficiaries of that trust, it was held on appeal (*Vanta Pty Ltd v Mantovani* [2023] VSCA 53) that sufficient evidence was present that the trust did not fail due to uncertainty.
- 3.7 In determining whether the trust failed for uncertainty, the Court considered whether it was necessary for there to be clear and convincing proof of the terms of the deed.
- 3.8 The Court noted that the Schedule provided satisfactory evidence of various matters related to the trust, namely:
- (a) the date of making the deed;
  - (b) the name of the trust;
  - (c) the settlor;
  - (d) the trustee;
  - (e) the settled sum;
  - (f) the appointor; and
  - (g) the beneficiaries.<sup>6</sup>
- 3.9 In the provision of such information, the Court noted that the Schedule “*identifies the essential terms of the Trust and meets the ‘three certainties’ test*”<sup>7</sup> in that:

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<sup>6</sup> *Vanta Pty Ltd v Mantovani* [2023] VSCA 53 at [103]

<sup>7</sup> *Vanta Pty Ltd v Mantovani* [2023] VSCA 53 at [105]



- (a) certainty of intention was present in light of the settlor's intention to establish the trust for the benefit of beneficiaries identified in the Schedule;<sup>8</sup>
  - (b) certainty of subject matter would include any assets transferred into the trust;<sup>9</sup> and
  - (c) certainty of object made it clear that an ascertainable and defined class of beneficiaries were named in the trust deed.<sup>10</sup>
- 3.10 The Court noted that a lack of secondary evidence as to management powers of the trust and the date of vesting of the trust should not be sufficient to fail the trust for uncertainty.<sup>11</sup>
- 3.11 Various other Court decisions exist that provides guidance as to the sufficient level of evidence required in order for the Court to hold the existence of a trust.
- 3.12 For contrast, we will provide a brief overview of such cases and the distinctive facts regarding the lost trust terms.
- 3.13 *Re Cleeve Group Pty Ltd* [2022] VSC 342:
  - (a) No executed copy of the trust deed could be found.
  - (b) Two competing versions of the trust deed were in circulation, being:
    - (i) a draft deed prepared in December 1999; and
    - (ii) a draft deed mirroring earlier family trust deeds prepared.
  - (c) Evidence exists whereby the December 1999 trust deed was circulated to financiers for review, as well as accounts and financial statements for the trust that *'could not have lawfully [been] done....if the trust deed had not been executed'*<sup>12</sup>.
  - (d) In contrast, the alternate version of the draft deed involved inconsistent recollections and metadata issues.
  - (e) The Court was satisfied that the draft deed prepared in December 1999 was likely executed.
- 3.14 *Re Thomson* [2015] VSC 370:
  - (a) Superannuation fund established by way of trust deed.
  - (b) A variation deed was executed but lost.
  - (c) An unsigned copy of the trust deed was relied upon.
  - (d) The case considered whether a 'presumption of regularity' could be applied so to render the variation deed as operative.
  - (e) Having considered the application of such presumption in other unrelated transactions, the Court noted that the *"presumption to this case would be such that the fact of the approval of the Fund's financial statements and reports by the deceased and his wife should be taken to mean that the necessary prior act, that is, the signing of the 2000 Deed that made them both trustees of the Fund, must have taken place or be probable that the 2000 Deed was duly executed"*.<sup>13</sup>

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<sup>8</sup> *Vanta Pty Ltd v Mantovani* [2023] VSCA 53 at [106]

<sup>9</sup> *Vanta Pty Ltd v Mantovani* [2023] VSCA 53 at [107]

<sup>10</sup> *Vanta Pty Ltd v Mantovani* [2023] VSCA 53 at [108]

<sup>11</sup> *Vanta Pty Ltd v Mantovani* [2023] VSCA 53 at [110]

<sup>12</sup> *Re Cleeve Group Pty Ltd* [2022] VSC 342 at [28]

<sup>13</sup> *Re Thomson* [2015] VSC 370 at [23]



- (f) Factors that the Court placed some weight on included the fact that no fraud is alleged; the fact there was no evidence of irregularity as well as the fact that the *“matter is some fifteen years in the past, and it seems unlikely that evidence could now be procured that would determine the issue of the execution of the relevant document”*.<sup>14</sup>

3.15 *Sutton v NRS(J) Pty Ltd* [2020] NSWSC 825:

- (a) The original trust deed cannot be located, however, a photocopy of a fully executed copy of the trust deed is locatable.
- (b) The trust was established in 1972 and remained dormant until about 2007 when steps were taken to amend the terms of the trust.
- (c) Subsequent to the acquisition of income producing assets in the trust, the trust's bank undertook a 'know your customer' review and in light of the failure to locate the original trust deed, the bank account of the trust was frozen.
- (d) Court noted that it was not necessary to rely on the presumption of regularity as a photocopy of the executed trust deed was in existence which sets out the terms of the trust.<sup>15</sup>
- (e) Court noted that the trustee of the trust would be justified in administering the trust on the basis of the photocopy of the full executed trust deed.

3.16 *Application of DEK Technologies Pty Ltd as trustee for DEK Technologies Unit Trust & Ors* [2023] NSWSC 544:

- (a) Original trust deeds were lost, however, evidence was provided by the accountant including a detailed letter of advice of the structure outlining the establishment of a unit trust with the family trusts (where the trust deeds were lost) as unitholders and setting out other various details.
- (b) The accountant provided evidence as to the trust provider they would use in the usual court, as well as the fact that amendments to the template were never requested.
- (c) Evidence of order form as well as the template of the trust provider were provided in the proceedings.
- (d) The Court accepted that the terms of such trusts could be inferred in light of the above evidence.

3.17 Of note in relation to the above cases is the fact that either the terms of the trust deed were locatable or parties with knowledge of such terms were able to provide such evidence during the proceedings.

3.18 The existence of such terms will be able to provide clients and advisors with the ability to seek judicial guidance in verifying the terms of a trust where a fully executed copy of the original is not locatable.

3.19 Care should be taken from preparing self-serving documents seeking to confirm the terms of a trust, as case law exists confirming that a document between certain parties purporting to correct historical discrepancies will not necessarily be binding on third parties (such as taxation/revenue authorities).

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<sup>14</sup> *Re Thomson* [2015] VSC 370 at [25]

<sup>15</sup> *Sutton v NRS(J) Pty Ltd* [2020] NSWSC 825 at [17]



- 3.20 In particular, in *Cessnock Tyres Pty Ltd v Chief Commissioner of State Revenue* [2017] NSWCATAD 368 the Tribunal largely agreed with the revenue authority that a 'Rectification Deed' purporting to amend the beneficiaries of a discretionary trust was not effective in breaking a payroll tax group.
- 3.21 Tax and stamp duty risks may also arise where advisors seek to 'sign a new trust deed template' where the terms of the trust may differ from the original trust deed.

## 4 What is 'real and genuine consideration' and its impact on annual distributions

4.1 It is well established that discretionary beneficiaries of a discretionary trust:

- (a) only have a 'mere expectancy' to receive any of the trust fund and cannot force a trustee to distribute trust funds in their favour<sup>16</sup> (subject to the rule of equity in *Saunders v Vautier*<sup>17</sup>); and
- (b) can only compel the trustee to properly administer the trust.<sup>18</sup> Specifically:  
*'[N]o object of a discretionary trust has, as such, any legal right to or in the capital. His sole interest, if it be an "interest" within the scope of these provisions is with regard to the income: he can require the trustees to exercise, in bona fide, their discretion as to how it shall be distributed, and he can take and enjoy whatever part of the income the trustee choose to give him. I cannot see any ground for holding that he can have any "interest" in the capital if he has no interest in the income.'*<sup>19</sup>

4.2 Even though the above common law statements arose from English cases, Australian law has adopted the conclusions:

- (a) Per Owen J in *R and I Bank of Western Australia Ltd v Anchorage Investments Pty Ltd* [1992] 10 WAR 59 at 79:  
*The trustee has a duty to administer the trust bona fide having regard to the purpose for which it was established. This is a duty which the court will enforce at the behest of the beneficiary. In this way, the remedy defines the nature of the interest of an individual beneficiary.*
- (b) Per French J in *Richstar Enterprises Pty Ltd and Others; Australian Securities and Investments Commission v Carey (No 6)* (2006) 153 FCR 509 at 29:  
*... in my opinion, in the ordinary case the beneficiary of a discretionary trust, other than perhaps the sole beneficiary of an exhaustive trust, does not have an equitable interest in the trust income or property which would fall within even the most generous definition of "property"....*
- (c) In *Kestenberg v Kestenberg* [2020] VSC 84 at 7:  
*[A] discretionary beneficiary has no proprietary interest, vested or contingent, in the assets of a trust but only an expectation...a discretionary beneficiary, is not entitled as of right to disclosure of that which could be properly described as 'trust document'*

4.3 The above cases reinforces the law that beneficiaries of a discretionary trust have no direct interest in the income and capital of the trust, and that the trustee (being the various companies) has the absolutely discretion to determine how such income and capital of the trust is to be distributed.

4.4 Notwithstanding the above case law, the case of *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 (**Owies**) confirmed that although beneficiaries cannot force distributions to be made in

<sup>16</sup> *Pearson v Inland Revenue Commissioner* (1981) AC 753

<sup>17</sup> The rule in *Saunders v Vautier* (1841) EWHC Ch J82 states that all beneficiaries of a trust can force the trustee to dissolve the trust and pay the trust fund. For a discretionary trust, this will need to include all Discretionary Beneficiaries including eligible trusts and companies

<sup>18</sup> *Gartside v Inland Revenue Commissioners* (1986) AC 553

<sup>19</sup> *Gartside v Inland Revenue Commissioners* (1986) AC 553 at 606



their favour, trustees must exercise any discretion having applied 'real and genuine' consideration to the decision.

- 4.5 *Owies* involved estranged children challenging decisions made by a trustee of a discretionary trust (in which the estranged children were named as primary beneficiaries with their parents and brother).
- 4.6 The case is one of many considering whether a trustee's decision of a discretionary trust may be challenged.
- 4.7 Courts will generally not question the merits of a discretionary decision taken by a trustee as they seek to abide by a 'principle of non-interference'<sup>20</sup>. This is due to Courts being reluctant to overturn the valid choice of persons to utilise such a discretionary structure – *[I]t is to discretionary of the trustees that execution of the trust is confided...* [However, the discretion must be exercised] *within an entire absence of indirect motive, with honesty of intention, and with fair consideration.*<sup>21</sup>
- 4.8 However, where a trustee has failed to exercise their discretion 'in good faith' Courts may consider the appropriateness of such decisions.
- 4.9 A lack of good faith can exist where a trustee:
- (a) fails to consider the intention of the trust's creator/settlor prior to making a decision;
  - (b) is deliberately deceptive for their personal gain or decisions are exercised with dishonesty; or
  - (c) fails to give real and genuine consideration to the exercise of their discretions.
- 4.10 Consideration will be had to some cases exploring what constitutes 'real and genuine consideration' before appreciating the facts of *Owies*.

### ***Hoh v Ying Mui Pty Ltd***<sup>22</sup>

- 4.11 This case related to a bitter family dispute between two factions of the Hoh family:
- (a) the George faction – based in Malaysia; and
  - (b) the Frank faction – based in Australia.
- 4.12 The dispute related to the actions of the Frank faction regarding multiple discretionary trusts (the Ying Mui Trust, The Amore Trust and FRG Investments Trust, collectively the **Trusts**) owning significant Australian assets (accumulated by Hoh Senior during his lifetime), whereby the Frank faction greatly benefited.
- 4.13 Such actions included:
- (a) selling assets held by the Ying Mui Trust to associated persons of the Frank faction;<sup>23</sup>
  - (b) deliberately misleading the George faction as to the assets and distribution holding of the trust;<sup>24</sup>

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<sup>20</sup> See G Thomas, *Thomas on Power* (1<sup>st</sup> edn), Sweet & Maxwell, London, 1998, at [6-204]

<sup>21</sup> *Re Beloved Wilkes Charity* (1851) 3 Mac & G 440; 45 ER 330 at 333

<sup>22</sup> [2019] VSCA 203

<sup>23</sup> *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 41

<sup>24</sup> *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 42



- (c) arranging for net income of the Ying Mui Trust to be distributed to associated persons of the Frank faction; and<sup>25</sup>
  - (d) entering into management fee agreements in favour of associated persons of the Frank faction.<sup>26</sup>
- 4.14 Such was the degree of abuse of power, the trial Courts ordered:<sup>27</sup>
- (a) a new trustee be appointed to each of the trusts and the trust assets be transferred to the new trustee;
  - (b) associated persons of the Frank faction pay equitable compensation to the new trustee in respect of management fees and trust distributions made; and
  - (c) the sales of properties from Ying Mui Trust be set aside and the properties retransferred to the Ying Mui Trust.
- 4.15 Much of the decision was made on the basis that the Frank faction breached their fiduciary or statutory duties for the Trusts by entering into management fee arrangements and making trust distribution payments; and such determinations were questioned on appeal.
- 4.16 For the purposes of this paper, the following was noted by the Court in determining that duties were breached by the Frank faction.
- 4.17 The Court held that the Frank faction were in a position of clear conflict of interest in addition to utilising their position as director of various corporate trustees to benefit their associated entities to the detriment of the corporate trustees, by entering into management fee agreements.<sup>28</sup>
- 4.18 Regarding the receipt of trust distributions as breaches of trust, it was noted that:
- (a) distributions should have been taken as having been motivated by the Frank faction's *'improper purpose of obtaining a 'fighting fund' to be used by the Frank faction against the George faction in anticipated litigation concerning the administration and control of the Ying Mui trust'*;<sup>29</sup>
  - (b) members of the Frank faction *'did not give any genuine consideration to how the discretion of appointment ought to have been exercised, or whether the 2012–2014 Distribution Payments were in the best interests of the present and future beneficiaries of the Ying Mui Trust and the Amore Trust'*.<sup>30</sup>
- 4.19 In addition, the trial judge (with the Court of Appeal) held that:<sup>31</sup>
- (a) any argument that the distributions were for the benevolent purpose of protecting the Trust funds from the George faction could not be relied upon as no such purpose existed on construction of the trust deeds;
  - (b) in exercising the trustee discretion to distribute, members of the Frank faction exercised their powers in bad faith and in a dishonest faction by concealing actions

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<sup>25</sup> *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 51

<sup>26</sup> *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 41

<sup>27</sup> *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 55

<sup>28</sup> *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 265

<sup>29</sup> *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 280

<sup>30</sup> *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 281

<sup>31</sup> *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 282



from the George faction, as well as for an improper purpose of establishing a fighting fund.

- 4.20 Certainly the existence of letters from the Frank faction to the George faction of the following effect, would cause concern as to the ability for those in the Frank faction making decisions relating to the Trusts to make such decisions with proper consideration as required under trust law:

*By letter dated 31 July 2010, she rejected the proposed meeting and stated that the dispute was 'past the point of discussion' because: 'MY DAD HAS MADE HIS DECISION — in his words, he wants "out" of all business associations with the extended Hoh family'.*

*Lynn said in her letter that her proposal: 'was a "cleaner" solution to my dad's initial intentions to effectively wind up all these businesses with a view to distributing the proceeds to relevant parties', [24] and continued: '[t]he only decision that needs to be made here is by you and uncle George — whether you want to accept my proposal as set out in my letter, or take your chances with what my dad will do if you reject my proposal'. [25] She set a deadline of 6 August 2010 for acceptance of her proposal and, on Frank's instructions, threatened that he would 'do it his way' if the proposal was not accepted by that time.<sup>32</sup>*

- 4.21 Further, the Court noted that "George's statements are consistent with him working for the whole family (including Derek and Richard) on behalf of SYM and with Frank acting for the narrower family (excluding Derek and Richard) on behalf of Ying Mui".<sup>33</sup>

#### **Callus v KB Investments<sup>34</sup>**

- 4.22 In contrast to the *Ying Mui* case, the Victorian case of *Callus v KB Investments* [2020] VCC 135 is example where by a disgruntled beneficiary could not establish the fact that the trustee 'was not in a position to give real and genuine consideration to the interests of the beneficiaries, or that it did not give real and genuine consideration of those interests'.
- 4.23 This was notwithstanding that the trustee of the trust in that case transferred a property to one of the beneficiaries over another and left no written reasons or record for making such a decision.
- 4.24 In that case, a disgruntled family member challenged the trustee's discretion to transfer trust property to one of four named beneficiaries in a discretionary trust deed.
- 4.25 The Court undertook to consider, not whether the final outcome was fair, but rather whether the trustee at the time had proper consideration as part of the process of making a decision.

#### **What is 'real and genuine consideration'**

- 4.26 The case provides a detailed summary of the relevant legal principles by referencing McMillan J in *Re Marsella; Marsella v Wareham (No. 2)* [2019] VSC 65.<sup>35</sup>
- 4.27 The key principles can be summarised as follows:
- (a) In accepting to be a trustee, the trustee is bound by duties to exercise their power in the best interest of beneficiaries.

<sup>32</sup> *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 38

<sup>33</sup> *Hoh v Ying Mui Pty Ltd* [2019] VSCA 203 at 140

<sup>34</sup> *Callus v KB Investments* [2020] VCC 135

<sup>35</sup> *Callus v KB Investments* [2020] VCC 135 at [141]



- (b) Where a trustee is provided 'unfettered discretion', such discretion must be exercised in good faith, upon real and genuine consideration and in accordance with the purposes for which the discretion was conferred.
- (c) In determining whether such discretion was exercised appropriately, a Court may look at the inquiries the trustee made, the information they had, and their reasons for, and manner of, exercising their discretion.
- (d) It is not the Court's role to determine the weight of such matters in the trustee exercising its discretion.
- (e) A lack of good faith can include the taking account of irrelevant considerations and a refusal to take into account relevant considerations.
- (f) The trustee must inform themselves of the relevant matters to exercise the discretion. Where the consideration is not properly informed, then it is not genuine.
- (g) Finally, the purpose for which a power is conferred on the trustee must be inferred from the trust deed.
- (h) Whether a trustee exercised a power for a proper purpose is a question of fact to be decided on the evidence. A trustee is not bound to disclose her or his reasons in reaching a particular decision, and a negative inference cannot be drawn from the non-disclosure by a trustee of the reasons for his or her decision.

4.28 In this case, the Court held that there was no proof that the trustee did not act honestly and in good faith. The Court considered the following:

- (a) the trustee exercised their discretion pursuant to the terms of the discretionary trust (including not being required to retain records of the decision or not being required to seek the guidance of the Guardians);<sup>36</sup>
- (b) the trustee exercised their discretion per an oral recollection from the prior decision-maker of the trust (being the father of those managing the trustee);<sup>37</sup>
- (c) there was no hostility between the trustee and disgruntled beneficiary at the time of the transfer (such hostility arising at a later point in time);<sup>38</sup> and
- (d) there was sufficient evidence that on the balance of probabilities, the trustee obtained appropriate legal advice regarding the deed prior to exercising its discretion.<sup>39</sup>

### **Owies**

4.29 The case revolved around the administration of a discretionary family trust established by John and Eva Owies in 1970.

4.30 The trust was structured with JEE Nominees Pty Ltd acting as trustee and John and Eva's children: Michael, Paul, and Deborah, as primary beneficiaries. John and Eva were also included as general beneficiaries.

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<sup>36</sup> Callus v KB Investments [2020] VCC 135 at [145] and [148]

<sup>37</sup> Callus v KB Investments [2020] VCC 135 at [149] and [150]

<sup>38</sup> Callus v KB Investments [2020] VCC 135 at [152]

<sup>39</sup> Callus v KB Investments [2020] VCC 135 at [153]



- 4.31 Whilst the trustee had broad discretionary powers to distribute the trust's income, the terms of the trust were drafted such that any 'default income' would be held by the trustee on trust for each of Michael, Paul and Deborah equally.
- 4.32 Much of the dispute related to various trust distributions made from 2011 to 2019 on the basis that:
- (a) From 2011 to 2018, the trustee allocated 40% of the trust's income to John, 40% to Michael, and 20% to Eva.
  - (b) In 2019, the trustee decided to distribute 100% of the income to John.
- 4.33 Accordingly, Paul and Deborah, challenged the trustee's decisions, arguing that the trustee failed to give "real and genuine consideration" to their interests, thus breaching its fiduciary duty.
- 4.34 The Victorian Supreme Court of Appeal found that the trustee had indeed breached its fiduciary duty by not properly considering whether distributions should be made to Paul and Deborah during the financial years ending 30 June 2017 and 2019. The court noted that the trustee's actions were influenced by strained family relationships and a lack of impartiality and a lack of impartiality. Consequently, the distributions made to John, Eva, and Michael were deemed voidable (albeit no order was sought to have the distributions set aside), and the Court ordered the removal of the trustee.
- 4.35 It is noted that both Paul and Deborah were both estranged from their parents at various points during the above period (whilst reconciling for periods as well) and Deborah in particular had medical conditions that affected her ability to work full-time for extended periods. In addition, Paul made enquiries relating to the trust to no avail.
- 4.36 In coming to their determination, the Court noted the following.
- (a) *'In considering the nature of the power to distribute annual income, the starting point must be the nature and purpose of the trust having regard to the terms of the trust deed. **The trust deed is by settlement, and as the preamble records, the settlor settled the sum 'being desirous of making provision for the Primary Beneficiaries and the General Beneficiaries'***<sup>40</sup>.
  - (b) *'Given its terms, it would have been expected that the class of general beneficiaries would not be particularly large and would continue to revolve around the three Owies children. An obvious, but unstated, premise on which the trustee would be expected to discharge its duties is that it would generally be informed about the differing circumstances, needs and desires of each beneficiary as an incident of the familial bonds that underpin the trust and explain its purpose.'*<sup>41</sup>
  - (c) *'The power in cl 3 to distribute annual income to the general beneficiaries is cast in the broad terms of 'an absolute discretion', a matter confirmed by the general provision of cl 17 that makes it plain that the trustee's powers are 'absolute and uncontrolled'. **Nevertheless, even such broadly expressed powers must be exercised in good faith and taking into account the purpose of the trust***<sup>42</sup>
  - (d) *'In looking at the nature and purpose of the power to distribute income, it is also relevant that the trust deed provides, in default of appointment of income, and assuming they are living, that the three children hold the income pursuant to an*

<sup>40</sup> *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 at [110]

<sup>41</sup> *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 at [111]

<sup>42</sup> *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 at [112]

*express trust in equal shares. The intention that the primary beneficiaries take any non-applied or accumulated income in the same manner as will occur with respect to the whole fund on vesting, reinforces the general default structure of the trust deed as one providing for the benefit of the children in equal shares.*<sup>43</sup>

4.37 In addition to the decision, appreciation should be had from the trust deed of the case to more modern deeds:

- (a) *'In the case of some trusts, the number of potential objects might be very large and a requirement to undertake a detailed analysis of the identity and needs of each would be unworkable. Having considered whether or not to exercise the power and understood the range of objects that might benefit, the trustee is required to give adequate consideration as to how to exercise the power.'*<sup>44</sup>
- (b) The fact that the children were listed as 'Primary Beneficiaries' and entitled to take the income or capital on default of any determination played a part in determining whether appropriate consideration were made to them.

### **Williams v Robba**<sup>45</sup>

4.38 Although this case involves a Trustee exercising their absolute discretion to pay out residual death benefits from a self-managed superannuation fund to a deceased member's benefits, the Court considered whether the Trustee exercised their discretion with due care and consideration.

4.39 The proceeding was brought upon by two children of the deceased who sought to challenge the Trustee's determination that the deceased's death benefits be distributed:

- (a) 50% to the deceased's second wife (less \$750); and
- (b) the remainder to a child of the deceased from his first marriage (on the basis that the child had health issues and was entirely dependent on the NDIS and family support).

4.40 The applicants sought that *"at least 95% of all available benefits, if not 100% of all available benefits, be accorded to Mr Peter Williams [the child of the deceased]"*<sup>46</sup>

4.41 Crucial in the Court's decision was the fact that the Trustee did in fact take appropriate steps to seek information regarding each potential beneficiary of the deceased's death benefits.

4.42 In determining that the Trustee exercised their discretion appropriately, the Court noted:

*[95] As to the second limb, the applicants submit that the Trustees failed to conduct adequate inquiries. On the Karger v Paul test, this is not made out. It is clear and uncontentious that the Trustees, through their lawyers, did in fact conduct inquiries about the needs of both Peter and Gayle, as well as all the other dependants. The Trustees first contacted all of the dependants and asked them to provide information generally relevant to the distribution of the residual death benefit. Over the course of weeks' worth of emails, the Trustees then contacted Paul, Mark and Louise asking for more specific details of their and Peter's financial needs and personal circumstances. This is again factually distinct from Owies, where inquiries were not made of some of the beneficiaries at all.*

<sup>43</sup> *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 at [113]

<sup>44</sup> *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 at [95]

<sup>45</sup> *Williams v Robba* [2025] QSC 203

<sup>46</sup> *Williams v Robba* [2025] QSC 203 at [33]



*[96] In the course of submissions, the applicants pointed out information that the Trustees did not have and could have sought, such as an alleged large amount of money that Gayle had but did not disclose, an expensive car she had allegedly owned, and exactly how much money Peter needed to be able to purchase secure accommodation. While this is true, **the fact remains that the Trustees made many inquiries as to the needs and circumstances of the dependants. The inquiries ultimately could have been more comprehensive. But I am satisfied on the material before me that the Trustees asked for and were provided with enough information to gather an adequate understanding of each of the dependants' positions in relation to the Fund. Under the test in Karger v Paul, there is no absence of real and genuine consideration. Rather, it appears to me that the Trustees made a conscious effort to inform themselves of and give due regard to relevant information.***

*[97] Even if I am wrong in that the more stringent duty from Finch applies such that the Court is allowed to impugn the inquiries made by the Trustees, I am not satisfied that that duty was not discharged by the Trustees. As I have said, **the Trustees communicated to all the dependants and asked relevant and specific questions about each of their financial circumstances over the course of a couple of months. They had enough information to make a reasoned decision as to how to distribute the residual death benefit.** Even a "more intense" duty for superannuation trustees to "properly inform themselves" and to "make such inquiries as they may reasonably consider relevant" would not require the Trustees to ask every single question that may be relevant*

**[emphasis added]**

- 4.43 Of note, it was noted that "the Court may examine the inquiries that were in fact made by the trustee to determine whether the inquiries demonstrate that the trustee exercised real and genuine consideration. But it is not for the Court to criticise the inquiries which were made or identify with any specificity what inquiries should have been but were not made. This is consistent with the general reluctance of courts to not interfere with the discretion of a trustee where a trustee has expressly been given wide power to make decisions – to conclude otherwise would, in my view, err too close to a court substituting its own processes and decision for that of the trustee."



## 5 Trust specific tax legislation

### Section 100A

- 5.1 Taxation Ruling TR 2022/4 (**TR 2022/4**), Practical Compliance Guideline 2022/2 (**PCG 2022/2**) and Taxpayer Alert TA 2022/1 (**TA 2022/1**) outlines the ATO's position in interpreting section 100A ITAA 1936.
- 5.2 Broadly, section 100A is an anti-avoidance provision designed to prevent tax avoidance through trust structures which applies when a beneficiary of a trust becomes presently entitled to trust income under a reimbursement agreement. A reimbursement agreement involves an arrangement where someone other than the beneficiary benefits from the trust income and the arrangement is made with the purpose of reducing tax **and** is not made in the course of an ordinary family or commercial dealing.
- 5.3 TR 2022/4 and PCG 2022/2 provides guidance on what the ATO will consider an ordinary family or commercial dealing.
- 5.4 A detailed analysis regarding section 100A, TR 2022/4 and PCG 2022/2 is outside the scope of this paper, however, consideration will be had regarding what records should be maintained to support tax effective distributions to adult children and bucket companies in light of such ATO guidance.

#### ***What is 'ordinary family or commercial dealing' in the context of the ATO guidance***

- 5.5 TR 2022/4 notes that whether there is an ordinary family or commercial dealing will depend on all the relevant circumstances which would require considering of the historical behaviour of parties and whether the dealing:<sup>47</sup>
  - (a) is artificial or contrived
  - (b) is overly complex
  - (c) contains steps that are not needed to achieve the family or commercial objectives, or
  - (d) contains steps that might be explained instead by objectives different to those said to be behind the ordinary family or commercial dealing.
- 5.6 The ruling notes that the *"test can involve an inquiry into what the objectives of the dealing are and whether the steps that comprise the dealing would achieve that objective. It can also be relevant to inquire whether the dealing or steps within the dealing might be explained instead by objectives different to those said to be behind the ordinary family or commercial dealing. Illustrations can be found in case law:*
  - (a) *In Prestige Motors, in concluding that the 3 transactions did not arise out of ordinary family or commercial dealing, the Court referred to the absence of commercial motivation or commercial necessity or justification for the transactions, and observed of one arrangement that the 'only explanation for the entry into the agreement ... [was] the elimination or reduction of tax liabilities'.*
  - (b) *In Guardian FCA, the Court (Logan J) identified an agreement involving the incorporation of a company, the nomination of that company as an eligible beneficiary of a trust that conducted investment activities and the subsequent appointment of income from those investment activities to the company. In concluding that the exception applied, the Court made findings on the evidence and*

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<sup>47</sup> TR 2022/4 at paragraph 27.



*posited that the identified agreement achieved the benefits of 'risk minimisation ... the shielding of distributed income and accumulated wealth from any creditors of individuals who were also members of the class of eligible beneficiaries' and the 'familial advantage ... of not having to make a large distribution in an income year to an individual'.*

- (c) *In BBlood FCA, in concluding the arrangement was not an agreement entered into in the course of ordinary family or commercial dealing, the Court observed that the arrangement was unusual, was more complex than was necessary to achieve any specific purpose that could be described as 'ordinary family or commercial dealing', and was neither explicable as being for family succession or for commercial purposes. Further, the Court considered the arrangements in the context of the historical behaviour of the parties, concluding that it was inconsistent with that behaviour and that no sensible commercial or family rationale had been established for adopting the buy-back procedure.*<sup>48</sup>

5.7 TR 2022/4 also acknowledges that cultural factors may inform the question on whether a dealing is an 'ordinary family dealing' distinguishing family dynamics where it is cultural for 'grandparents [to gift]...money or goods to younger members of the family'<sup>49</sup> to those where a beneficiary 'for religious reasons will not accept the entitlement'.<sup>50</sup> Consideration may also be held whether cultural practices of a family group extends to circumstances where it is expected that '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'.<sup>51</sup>

5.8 Ultimately, what constitutes an 'ordinary family dealing' requires an understanding of a family group's circumstances and arrangements for one client may not necessarily be suitable for another.

5.9 Example 8 of TR 2022/4 notes how the inclusion of any of the following factors may impact the ordinary family dealing of parents making a trust distribution to an adult child to assist with the purchase of a home:

- (a) *"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*
- (i) *the parents have a lower marginal tax rate*
  - (ii) *the parents have lesser financial means than the adult child, or*
  - (iii) *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.*
- (b) *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.*

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<sup>48</sup> TR 2022/4 at paragraph 98

<sup>49</sup> TR 2022/4 at paragraph 110

<sup>50</sup> TR 2022/4 at paragraph 113.

<sup>51</sup> TR 2022/4 at paragraph 111.



- (c) *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."*
- 5.10 Given the prevalence of trusts as a business and investment vehicle, it is acknowledged that undertaking the above analysis for each family group may not be possible.
- 5.11 Accordingly, PCG 2022/2 provides 'Green zone' scenarios in which the ATO will not dedicate compliance resources given the low risk nature of such examples.
- 5.12 It should be noted that PCG 2022/2 does not state the law, but rather outlines scenarios that are more likely to be criticised than others.
- 5.13 In relation to a company beneficiary, Scenario 3B of PCG 2022/2 notes that distributions to a company beneficiary may fall within the green zone where:
- (a) there is a retention of funds;
  - (b) the company is not an exempt entity;
  - (c) the company is a member of the same family group (see paragraph 25(f) for the meaning of family group);
  - (d) 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 (as well as other circumstances – see paragraph 25(c) for additional circumstances and paragraph 25(d) for situations when this condition will not be met);
  - (e) a complying Division 7A loan agreement is entered into (note TD 2022/2 discussed above);
  - (f) none of the following exclusions apply.<sup>52</sup>
    - (i) *the arrangement is a red-zone arrangement (see paragraphs 34 to 48 of PCG 2022/2)*
    - (ii) *the beneficiary makes a gift of the funds received either in satisfaction of their trust entitlement or from an associated amount (an example of an associated amount includes where the unpaid present entitlement (UPE) was converted into a loan) except where the gift meets the requirement of Green zone: scenario 1*
    - (iii) *the beneficiary disclaims their entitlement or forgives or releases the trustee from its obligation to pay their trust entitlement or an associated amount receivable from the trust (an example of an associated amount is where the UPE was converted into a loan)*
    - (iv) *the beneficiary's entitlement is less than the beneficiary's share of net income, franked dividends of the trust and trust capital gains as a result of the trustee exercising a power, or the deed being amended or varied, to affect the quantum of income of the trust estate*
    - (v) *a beneficiary's trust entitlement is satisfied by payments that are sourced from that beneficiary, or a beneficiary's trust entitlement has been made subject to a loan agreement and the repayments of that loan are sourced*

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<sup>52</sup> PCG 2022/2 at paragraph 32.





*from payments or loans from that beneficiary; examples include where a trustee*

- (A) satisfies a corporate beneficiary's UPE or makes a loan repayment to that corporate beneficiary by way of set-off against a dividend paid by that corporate beneficiary*
- (B) issues units in the trust to the beneficiary and the amount owed for the units is set-off against the amount payable by the trust to the beneficiary, or*
- (C) satisfies a beneficiary's entitlement or satisfies a loan repayment to that corporate beneficiary by way of set-off against that trustee's entitlement to income of another trust that includes franked distributions paid by that corporate beneficiary*
- (vi) the beneficiary is a loss company or loss trust that uses its trust entitlement to fund a distribution to its members and that distribution compromises the ability of the beneficiary to repay its existing or future liabilities*
- (vii) the beneficiary is a private company that uses its trust entitlement to fund a distribution that is made directly or indirectly to a non-resident*
- (viii) the beneficiary is a private company or trust that uses its trust entitlement to fund a distribution that is made directly or indirectly to the trustee that made the beneficiary presently entitled to income*
- (ix) the trustee has not notified the beneficiary of their entitlement to trust income by the earlier of the trustee's due date and actual date of lodgment*
- (x) where the beneficiary that is presently entitled to trust income in a year is required to lodge a tax return for that year, either the*
  - (A) beneficiary has not lodged, or*
  - (B) the beneficiary has understated or omitted in that tax return their share of the trust net income, trust capital gains or franked dividends received from the trust*
- (xi) the beneficiary uses the trust entitlement to pay excessive consideration where the parties are not dealing at arm's length.*

5.14 Accordingly, where distributions are made to a company beneficiary, written evidence should be retained to confirm the applicability of Scenario 3B. Such evidence can include:

- (a) The entering into a complying Division 7A loan agreement.*
- (b) Evidencing the use of such retained funds in the working capital for the trust (whether noting by way of resolution, notes or records of discussions or meetings).*
- (c) Ensuring appropriate accounting records are retained.*
- (d) Evidencing any future dividend declared are sourced separate from the trust distribution.*

5.15 In determining whether to make trust distributions to adult child, care must be taken in light of:

- (a) Red Zone scenario 1 of PCG 2022/2 – which involves an adult beneficiary in receipt of a trust distribution making gifts or loans to another party where such:*



- (i) distribution is paid to the parent or caregiver of the beneficiary in connection with expenses incurred before the beneficiary turned 18 years of age;
  - (ii) 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
  - (iii) 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.
- (b) TA 2022/1 – which outlines the scenarios in which the ATO will consider parents as benefiting from trust distributions made to adult children. Such arrangements cause concern given the ability to access tax-free thresholds or lower marginal tax rates of such adult children.<sup>53</sup>
- 5.16 TA 2022/1 provides the following two examples of trust distributions to adult children failing to fall within the meaning of ordinary family dealing.

**Example 1**

*7. The ABC Trust's beneficiaries include the members of the ABC Family. David is the sole trustee of the ABC Trust. David and his wife Rani have two children, Jenny (aged 22) and Paul (aged 19), who live with them in the family home. David and Rani have an existing mortgage on the home. Jenny and Paul are both full-time students and during the 2020–21 income year, they each earned approximately \$12,000 from casual employment.*

*8. During the 2020–21 income year, the ABC Trust derives income of \$720,000 (the trust's net income is also \$720,000).*

*9. A resolution of the trustee of the ABC Trust dated 30 June 2021 shows both Jenny and Paul are each presently entitled to \$160,000 of the income of the ABC Trust, with David and Rani each presently entitled to \$200,000.*

*10. Jenny and Paul are not paid any amounts. Instead, David transfers an amount equal to their entitlements to the mortgage offset account that he and Rani maintain. Jenny and Paul's entitlements are recorded as having been fully paid in the accounts of the ABC Trust. David pays Jenny and Paul's tax liabilities in relation to their entitlements from his personal funds.*

*11. David has taken these actions as Jenny and Paul have agreed that their entitlements from the ABC Trust will be managed by David for the benefit of all family members. David has determined that those entitlements should be applied to reduce the debt on the family home.*

*12. This arrangement raises the concerns mentioned in this Alert. By entering into this arrangement, the purported \$160,000 entitlements of both Jenny and Paul are not subject to the top marginal tax rate. David has not managed the entitlements for the benefit of all members of the family. The arrangement has the result that the post-tax amounts of Jenny and Paul's entitlements have been diverted to meet their parent's individual liabilities in circumstances where their parents would have been able to meet them. David and Rani receive the same economic benefit from that income as if it had been appointed to them directly, but without the amounts being included in their assessable income and subject to tax at a higher marginal tax rate. The arrangement involving the making of the trust*

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<sup>53</sup> TA 2022/1 at paragraph 3.



*distributions and use of those amounts appears to be motivated by the tax outcome achieved rather than ordinary familial objectives.*

### **Example 2**

*13. The trustee of the Blue Family Trust is Azure Pty Ltd. Trevor is the sole shareholder and controller of Azure Pty Ltd. The Blue Family Trust derives assessable income in excess of \$400,000 a year. Trevor's daughter, Simone, is a beneficiary of the trust. Simone has recently turned 18 years of age and works part-time. Simone expects to derive assessable income from her work of approximately \$20,000 a year.*

*14. Before the end of the 2020–21 income year, Simone meets with her father and agrees that any distribution resolved to be made by the Trustee will, after the payment of tax, be paid to Trevor to reimburse him for part of the fees for secondary schooling and costs of other extracurricular activities since Simone was five years old. Records maintained by the family show that these expenses amounted to \$315,000.*

*15. The Trustee resolves to distribute \$160,000 to Simone and pays this amount into an account held in Trevor's name. Trevor pays income tax on Simone's behalf.*

*16. This arrangement raises the concerns that are mentioned in this Alert. Simone is purportedly made entitled to a trust distribution and this amount is used to reimburse her parents for expenses that they would ordinarily meet. The arrangement, which results in Trevor obtaining the economic benefit of the trust income without that income being subject to tax at the top marginal tax rate he would otherwise have paid, appears to be more readily explained by the tax outcomes achieved, rather than any familial objectives.*

- 5.17 In contrast, Example 3 TA 2022/1 differs from Example 2 above by noting that the expenses in which the child repays would be considered legitimate expenses that an adult child may incur (e.g. university tuition fees and arm's length board):

*"17. The Green Trust's beneficiaries include the members of the Green Family. Mary Green is the sole trustee of the Green Trust. Mary has an adult child, Genevieve (aged 19), who lives with her grandmother in order to be close to the university she attends.*

*18. It is agreed between Mary and Genevieve that Genevieve's tuition fees of \$20,000 will not have to be met by Genevieve but that they will be paid out of her trust entitlement. It is agreed between Genevieve and her grandmother that the grandmother will be paid board of \$10,000 a year.*

*19. During the 2020–21 income year, the Green Trust derives income of \$300,000 (the trust's net income is also \$300,000).*

*20. On 30 June 2021, Mary as the trustee of the Green Trust resolves to make Genevieve presently entitled to \$40,000 of the trust income and make Mary entitled to the remaining \$260,000.*

*21. \$20,000 of the \$40,000 that Genevieve is presently entitled to is paid to Mary, who has previously met the tuition fees of \$20,000 as they fell due. \$10,000 of that \$40,000 is paid directly to the grandmother. The remaining \$10,000 is paid to Genevieve, some of which is used to meet her tax obligations on the \$40,000.*

*22. Although \$30,000 of the \$40,000 is not received directly by Genevieve, and might appear to be within the scope of this Alert, it is important that the \$30,000 is applied to repay loans for legitimate expenses that might ordinarily be borne by an adult child and were temporarily met on Genevieve's behalf (being tuition fees and arm's length board). The remaining*



*\$10,000 was actually received by Genevieve. Accordingly, the concerns raised in this Alert do not arise in arrangements of this type.”*

- 5.18 An important distinction between Examples 2 and 3 of TA 2022/1 is whether the ‘reimbursement’ to the parent from the child (using the trust distribution funds) is in relation to expenses incurred by the parent whilst the child was a minor or over 18. Where the reimbursement relates to expenses incurred whilst the child was a minor, such reimbursements would fall within Red Zone scenario 1 of PCG 2022/2.
- 5.19 Other than considering the above ATO guidance, steps should be taken to ensure the proper administration of the trust.
- 5.20 This may include the following:
- (a) Appropriate steps to ensure trust resolutions are prepared pursuant and in compliance with the terms of the trust deed.
  - (b) Ensuring each beneficiary recipient is advised of their entitlements in writing.
  - (c) Ensuring the accounts of the trust properly reflect the treatment of such entitlement.
  - (d) 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.
    - (i) In considering this step, thought should be had to ATO commentary at the time.
    - (ii) This may include ensuring proper evidence and records are retained as to any expenses incurred by an adult child but paid for by another family member.
    - (iii) Where there are dealings amongst related family members, thought should be had whether such dealings may also be considered arm’s length.
- 5.21 Importantly, trustees of a trust should not be seen as influencing beneficiaries in making such decisions relating to their entitlement prior to any trust distribution. This may mean that beneficiaries are informed of their ability to seek payment of their entitlement in cash, if they so choose.

## Subdivision EA

- 5.22 In light of the fact that (as of the date of this paper) the High Court of Australia has granted the ATO special leave to appeal the decision in *Commissioner of Taxation v Bendel* [2025] FCAFC 15 (**Bendel**), this paper will not consider the technical discussion on whether an unpaid present entitlement is a loan for Division 7A purposes.
- 5.23 Rather, this section will consider the often-missed Division 7A Subdivision EA ITAA 1936 rules that may impact private client groups (and was raised in the case of Bendel).
- 5.24 Subdivision EA will apply if:
- (a) *a trustee makes a loan (including a loan through an interposed entity as described in section 109XG) to a shareholder or an associate of a shareholder of a private company (except a shareholder or associate that is a company) (the actual transaction); and*

- (b) *either:*
- (i) *the company is presently entitled to an amount from the net income of the trust estate at the time the actual transaction takes place, and the whole of that amount has not been paid to the company before the earlier of the due date for lodgment and the date of lodgment of the trustee's return of income for the trust for the year of income of the trust in which the actual transaction takes place; or*
  - (ii) *the company becomes presently entitled to an amount from the net income of the trust estate after the actual transaction takes place, but before the earlier of the due date for lodgment and the date of lodgment of the trustee's return of income for the trust for the year of income of the trust in which the actual transaction takes place, and the whole of the amount has not been paid to the company before the earlier of those dates.*<sup>54</sup>

5.25 Where a discretionary trust has a UPE owed to a company and said trust also lends monies to a shareholder or an associate of a shareholder of that company, then section 109XB ITAA 1936 applies to such amount *"as if it were a dividend paid by the company at the end of the year of income of the company in which the actual transaction took place, in the assessable income of the shareholder or associate referred"*<sup>55</sup>

5.26 In practice, Subdivision EA expands the advisor headache of:  
managing client transfer of funds from a company out (in which case Division 7A may apply),  
to:

managing client transfer of funds from a trust where a UPE exists to a company (in which case Subdivision EA may apply even where a sub-trust arrangement was implemented as noted under the old TR2010/3 rules (withdrawn as from 2022)).

5.27 Whilst the introduction of TD 2022/11 reduced the potential relevance of Subdivision EA due to the ATO position that UPEs were required to be converted to loans within the applicable timeframe; the Bendel decision determining that UPEs were not loans for Division 7A purposes may yet bring Subdivision EA into the spotlight as private groups choose to retain UPEs between company and trust rather than converting them into a Division 7A compliant loan arrangement.

## Trust losses

5.28 Later sections of this paper will consider the requirements under various tax provisions to utilize trust losses in a discretionary trust.

5.29 This section considers the need for the trust deed to be reviewed to confirm whether the trustee has the power to determine whether or not to offset prior year trust losses.

5.30 The importance of a trustee having the ability to determine whether or not to offset prior year trust losses is highlighted due to the traditional rule in *Upton v Brown* (1879) 12 Ch D 872 that prior year losses must be recouped against current year distributable income.

5.31 This power can be useful where there is a disparity between trust losses and tax losses – for instance, a trust fails the trust loss tests and so cannot claim the benefit of prior year losses. If the rule in *Upton v Brown* is not displaced in this situation, it is possible to have a section

<sup>54</sup> Section 109XA ITAA 1936

<sup>55</sup> Section 109XB(1) ITAA 1936



99A situation where trust losses reduce distributable income to nil but there is still positive net taxable income for the trust.

5.32 For example, consider the following circumstances:

- (a) Trust carries forward losses equal to \$80,000.
- (b) Trust derives franked dividends equal to \$75,000 with \$25,000 franking credits attached.
- (c) Income of the trust is defined in the deed as 'income according to ordinary accounting principles'.
- (d) There is no provision in the trust deed that enables the trustee with the power not to offset prior year trust losses.
- (e) A's carry forward losses exceed the income derived from income (according to ordinary concepts), there is no distributable income of the trust.
- (f) There would be net taxable income of \$20,000, however, and as no beneficiary can be made as presently entitled (due to there being no distributable income), the franking credits would not be refundable.

5.33 Earlier sections of this paper considered the distinction between distributable income and net taxable income in further detail.

## 6 Family trust elections and interposed entity election issues

- 6.1 The need to make a family trust election may impact on trust distributions to be made. This is because once a family trust election is made, a Test Individual (discussed further below) and their **family group** may receive distributions from the trust without adverse tax implications
- 6.2 Specifically, a family trust election may be made to assist with any of the following:
- (a) Enabling a discretionary trust to utilise trust losses (discussed in this section given the relevance of trust losses in considering the making of trust distributions).
  - (b) Assisting a company with a discretionary trust shareholder to satisfy the company loss provisions.
  - (c) Enabling a discretionary trust to satisfy the holding period rule for franking credits.
  - (d) Meeting the ultimate economic ownership rules of the small business restructure rollover of Subdivision 328-G.
- 6.3 Schedule 2F of ITAA 1936 contains the relevant legislation regarding the ability to utilise trust losses.
- 6.4 Due to the difficulty of a discretionary trust to utilise existing tax losses via a distribution from another discretionary trust, it is common to see family trust elections being made over the trust.
- 6.5 This is because ordinarily a standard discretionary trust would be considered a 'non-fixed trust' for the purposes of the trust loss provisions. In being a non-fixed trust, four tests are required to be met for that discretionary trust to potentially utilise trust losses.
- 6.6 These four tests are the:
- (a) Pattern of distributions test – which requires an analysis of a trust's distribution year-on-year to ensure the loss may be carried forward (and historical trust distributions may impact the ability to meet this test in the event a family trust election is sought in the future). This test will be considered further below.
  - (b) Control test – which requires an analysis of the persons who may control the trust from the year in which the loss was incurred and the year in which the loss will be utilised.
  - (c) 50% stake test – which requires individuals with a 50% stake in the relevant trust to remain, which is difficult in relation to non-fixed trusts.
  - (d) Income injection test – Which is failed if an 'outsider' provides a benefit to the trust. Where no family trust election is made in relation to the trust, an 'outsider' is a person other than the trustee of the trust or a person with fixed entitlements to a share of the income or capital of the trust, meaning the only way to meet this test without a family trust election is if the trust itself generates income (i.e. the trust cannot receive income from external sources to offset against the loss).
- 6.7 It is difficult to ordinarily meet all four tests (or the compliance burden may be uncommercial), and is impossible to meet the income injection test for the trust if the trust receives a trust distribution from another discretionary trust (in the process of having its losses utilized).
- 6.8 In contrast, if a discretionary trust makes a family trust election, it is only required to satisfy the income injection test (modified to limit who is considered an outsider) in order to utilise



trust losses. The disadvantage in making the election is the reduction of the class of beneficiaries of the trust to those within a 'family group' and the application of a Family Trust Distribution Tax where distributions are made outside this 'family group'.

### ***Making a family trust election***

- 6.9 Subdivision 272-D ITAA 1936 outlines the circumstances in which a family trust election can be made over a trust.
- 6.10 Specifically, section 272-80 ITAA 1936 provides for the following:
- (a) A trustee of a trust may make a family trust election in a specified income year.
  - (b) The election must be made in writing and in the approved form.
  - (c) The election must specify an individual whose family group is to be taken into account regarding the election (**selecting a Test Individual**).
  - (d) The trust must pass the family control test (**Family Control Test**). A trust passes this test if a Test Individual and/or members of the family (collectively, the **group**), control the trust from the specified year in which the family trust election starts (**Commencement Year**) until the income year before the election year is made (**Current Year**).
  - (e) The specified income year may be made before the year in which the election is made if:
    - (i) at all times from the beginning of the specified income year until 30 June of the income year in which the election was made – the trust passes the Family Control Test; and
    - (ii) any conferrals of present entitlement or distributions made during the above period was only made to the Test Individual and members of the Test Individual's family (**Family Distribution Test**). That is, all distributions from the trust from the Commencement Year to the Current Year must have been made to the Test Individual or their family group.
- 6.11 The remaining provisions of section 272-80 ITAA 1936 relate to the revoking and varying of the family trust election and are not relevant for the purposes of making a family trust election.

### ***Selecting a Test Individual***

- 6.12 Selecting a Test Individual is crucial in satisfying the relevant tests and acknowledging who are entitled to receive distributions from the trust which a family trust election has been made.
- 6.13 As outlined above, once a family trust election has been made, a Test Individual and their **family group** may receive distributions from the trust without adverse tax implications. Distributing outside the family group after a family trust election has been made results in a Family Trust Distribution Tax being levied on the distribution.
- 6.14 Care needs to be taken a 'distributes' takes on a broader meaning (pursuant to sections 272-45 to 272-60 Schedule 2F ITAA 136) which can include (but is not limited to):
- (a) Paying (including by way of a loan) or credits money to a person or reinvests much for a person.
  - (b) Transferring property to an entity or allowing the use of property of the entity to a person.





- (c) Extinguishing, forgiving, releasing or waiving a debt or other liability owed by a person.
- (d) The buy-back of share capital.

6.15 A **family group** includes (per section 272-90 ITAA 1936):

- (a) A family member of the Test Individual (as provided for in section 272-95 ITAA 1936) which includes:
  - (i) any parent, grandparent, brother or sister of the Test Individual or the Test Individual's spouse;
  - (ii) any nephew, niece or child of the Test Individual or the Test Individual's spouse;
  - (iii) any lineal descendant of a nephew, niece or child referred to above;
  - (iv) the spouse of any of the persons referred to above.
- (b) Certain former family members.
- (c) The trust which made the family trust election.
- (d) Any trust which has made a family trust election with the same Test Individual.
- (e) Any entity which has made an interposed entity election.
- (f) Any entity in which the Test Individual or their family (or relevant entities) own the entity.
- (g) Certain tax exempt bodies.

6.16 Selecting an appropriate Test Individual will allow for the Trust to receive distributions from 'external trusts' as the Income Injection Test will be met.

6.17 Section 270-10 ITAA 1936 outlines the Income Injection Test.

6.18 At it's simplest, the test will be failed where an outsider of the trust provides a benefit to the trust as part of a scheme.

6.19 An 'outsider' to a family trust is defined in section 270-25(1) ITAA 1936 to be a person other than certain persons, including a trust with the **same Test Individual** specified in its family trust election; or a trust which has made an interposed entity election to be included in the Test Individual's family group.

#### ***Risk of Family Trust Distribution Tax***

6.20 In light of the broadened definition of 'distributes', care must be taken with discretionary trusts who have made family trust elections to ensure that distributions with persons outside the 'family group' are performed at market value.

6.21 ATO ID 2004/162 considered whether Family Trust Distribution Tax applied to a redemption of units where the amount paid exceeded the value of any consideration given in return. The ATO determined that Family Trust Distribution Tax would apply to the extent that the payment made in respect of the redemption exceeded the value of any consideration given in return.

6.22 Other examples of distributions that may result in Family Trust Distribution Tax include:

- (a) The transfer of shares by a family trust for less than market value to another family trust that is not within the family group – see section 272-60(1) Schedule 2F ITAA 1936.



- (b) Dividends declared by a company (which has made an interposed entity election linked to Person A) to a newly introduced shareholder family trust (which has made a family trust election in favour of Person B) which does not fall within the family group of Person A – section 272-50 Schedule 2F ITAA 1936.
  - (c) The transfer of business assets out of a company (which has made an interposed entity election linked to Person A) to an entity controlled by Person B (and which Person A has no involvement with) – section 272-60 Schedule 2F ITAA 1936.
- 6.23 A key theme of managing the above risks is to take care when dealing with a company that may have made an interposed entity election. When acting on behalf of a purchasing entity, appropriate due diligence must be undertaken.
- 6.24 Other than consideration of the broadened definition of 'distributes', care should be had when making a trust distribution from a discretionary trust that has made a family trust election. Prior to such distribution resolution being executed, steps should be taken to confirm any recipient beneficiary falls within the definition of family group, as well as within the general class of beneficiaries in the trust deed.

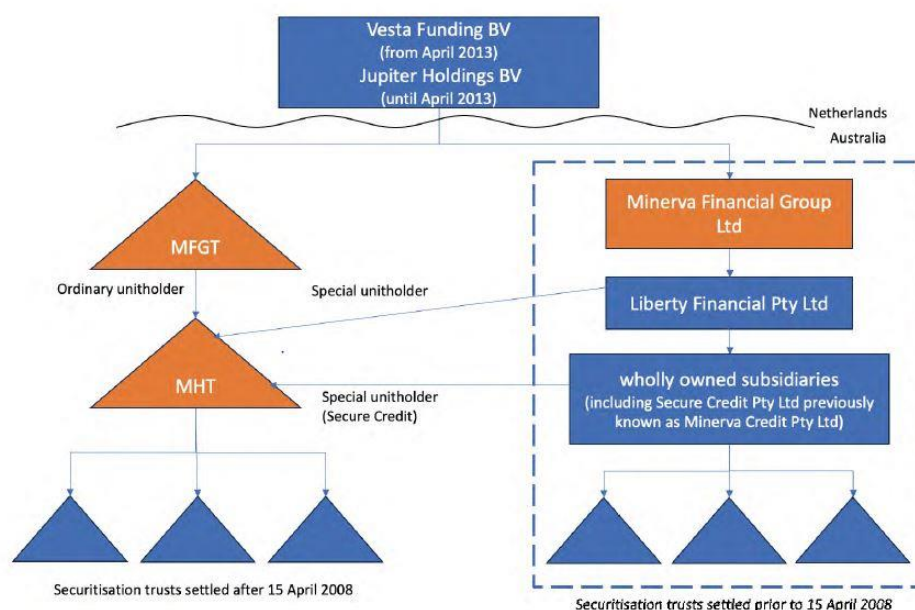


## 7 Part IVA and discretionary trust distributions

- 7.1 Notwithstanding the various trust specific provisions that may apply to particular trust distributions, the general anti-avoidance rules of Part IVA remain an option for the ATO to utilize in certain circumstances.
- 7.2 Whilst the decision in *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2022] FCA 1092 (**Minerva**) brought cause to concern when the Commissioner successfully argued that Part IVA applied to certain schemes which included a trustee's distribution decision.
- 7.3 Minerva has since been overturned at appeal *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 (**Minerva Appeal**), however, such outcome has not changed the Commissioner's position in relation to their long-held view that schemes which include a trustee's exercise of discretion to distribute income can attract the operation of Part IVA as they have outlined in their Decision Impact Statement of the Minerva Appeal.

### Minerva

- 7.4 Minerva involved three 'Schemes', two of which were initially determined to potentially fall foul of Part IVA.
- 7.5 Relevant to the facts of Minerva was a restructure that resulted in two Siloed Groups of entities owned by an international holding entity:
- (a) The Corporate Silo comprised of Minerva Financial Group Ltd as well as:
    - (i) Liberty Financial Pty Ltd (as subsidiary); and
    - (ii) Various other wholly owned subsidiaries to Liberty Financial Pty Ltd; and
  - (b) The Trust Silo which comprised of various securitized trusts under a holding trust (Minerva Holding Trust (**MHT**)), of which another trust (**MFGT**) was the sole ordinary unitholder in MHT.
- 7.6 A diagrammatic summary of the structure is as follows:



- 7.7 The Second and Third Schemes effectively involved:
- (a) the trustee of MHT choosing not to exercise its discretion to make any substantive distribution to the special unitholders (Liberty Financial and the wholly owned subsidiaries); and
  - (b) the trustee of MHT lending monies to Liberty Financial (with interest applying).
- 7.8 The resulting effect is that distributions from the Trust Silo (which included the interest received from the loan to Liberty Financial) would be subject to 10% withholding tax, whilst distributions from the Corporate Silo attracted a 30% tax rate.
- 7.9 At first instance, the Court noted:<sup>56</sup>
- [564] The applicant was unable to provide any cogent reason, other than the tax benefit, why the decision was taken in each of the relevant years to direct no more than 2% of MHT's net income to the special unitholders. The applicant submitted that neither LF nor Secure Credit had an "entitlement" to the income from the RIUs and that the power of the trustee of MHT to distribute income to the special unitholders was discretionary. So much, unsurprisingly, was accepted by the Commissioner. But neither factor goes to the relevant question of dominant purpose, objectively viewed.*
- [565] In those circumstances, I agree with the Commissioner's submission that, viewed objectively, the exercise of the choice in each of the relevant years (the manner in which the second part of the second scheme was carried out) was driven by the tax benefit of directing income away from LF. Having found that this factor is neutral insofar as it relates to the first part of the second scheme, I agree with the Commissioner's submission that, objectively, the manner in which the second scheme was entered into is indicative of a dominant purpose of obtaining that tax benefit.*
- 7.10 Accordingly, it held that Part IVA could apply, but more worrisome, Minerva provided some scope for a trustee's discretionary decision-making role to be scrutinised through Part IVA. In Minerva the trustee's decision scrutinised was the non exercising of a discretion to make a distribution to the special unitholders (being entities within the Corporate Silo).

## Minerva Appeal

- 7.11 On 8 March 2024, the Full Federal Court allowed the taxpayer's appeal of the Minerva decision.
- 7.12 While a full analysis of Part IVA is outside the scope of this paper, the Court noted the following in rejecting the conclusion of the primary judge.
- (a) Part IVA requires an objective assessment of the purpose behind entering into or executing the scheme, based on the statutory factors listed in section 177D of the Income Tax Assessment Act 1936.
  - (b) It does not allow for an investigation into the subjective motives of the taxpayer or other participants.
  - (c) The test for determining dominant purpose is not a "but for" test and does not involve causation.

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<sup>56</sup> *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2022] FCA 1092 at paragraphs [564] and [565]



- (d) Simply choosing between two transaction forms based on tax considerations does not, in itself, indicate that the scheme was entered into with the dominant purpose of obtaining a tax benefit, considering the section 177D factors.
  - (e) Part IVA does not mandate that a taxpayer must choose a transaction form that results in the highest or higher tax payable.
- 7.13 After restating these principles, the Full Court identified a “difficulty” in the primary judge’s reasoning. The judge concluded that the taxpayer’s inability to provide a convincing reason (other than the tax benefit) for its income distribution decisions suggested that the manner and timing of the schemes indicated the schemes were entered into for the dominant purpose of obtaining a tax benefit.
- 7.14 This approach conflated the objective determination of purpose with an inquiry into whether the trustee’s discretion would have been exercised differently without the tax benefit. The Full Court reiterated that purpose must be determined objectively, and subjective commercial reasons or motives do not answer the question posed by Part IVA.
- 7.15 On appeal, the Commissioner argued that the Liberty Financial group’s conduct before its restructure into the Corporate Silo and Trust Silo supported the conclusion that the schemes were entered into with the dominant purpose of obtaining a tax benefit. The Commissioner viewed the pre-reorganisation characteristics as a lens to understand the objective purpose of subsequent conduct. However, the Full Court found two fundamental flaws in this argument, being:
- (a) The reorganisation into Corporate Silo and Trust Silo was not challenged as a scheme on appeal.
  - (b) The group’s business had grown significantly and its funding sources had changed, making it inappropriate to use pre-restructure characteristics to draw conclusions about post-restructure conduct.
- 7.16 After recognizing that the Corporate Silo and Trust Silo were part of a legitimate restructure, the focus shifted to whether the specific method of making distributions within that structure triggered Part IVA.
- 7.17 The Full Court further determined that the trustee of the MHT simply distributed income according to the MHT’s constitution and the terms of the issued units (which had their “expected features”), and these distributions provided real benefits to the unitholders.

*[76] The features relied upon by the appellant are relevant to a consideration of the manner in which the “schemes” were carried out. The distribution resolutions were made by the appellant as trustee of MHT in accordance with the terms of the MHT constitution. The objective facts were that the special unitholders had no entitlement to the income of MHT absent of the exercise of the trustee’s discretion. The default position under the terms of the MHT constitution was that distributable income would be distributed to the ordinary unitholders. Objectively there was nothing extraordinary about distributions flowing in accordance with the terms of the trust constitution. The terms of issue of the units were the “expected features” of the units. A payment of distributions in accordance with their terms of issue is not an objective matter that points to a party carrying out the scheme for the dominant purpose of enabling the taxpayer to obtain a tax benefit.*

*[77] Absent anything further in the surrounding circumstances, the manner in which distributions were made does not objectively support a conclusion that a party entered into*



*or carried out any of the schemes for the dominant purpose of enabling the appellant to obtain a tax benefit.*<sup>57</sup>

7.18 In addressing the fact that the trustee discretion was exercised at the end of each financial year, the Full Court noted that they were exercised in accordance with *“terms of the MHT constitution and the need for the trustee to make a resolution to distribute the income of the trust by the end of the financial year. The time of the making of the resolution tells one nothing about the dominant purpose of a party in this case.”*<sup>58</sup>

7.19 Further, in rejecting the Commissioner’s contention, regarding the change of financial position of persons connected with the taxpayer, that *‘it was reasonably foreseeable that at the time the trustee decided not to exercise its discretion to “direct MHT’s net income” to the special unitholders in the relevant years, LF’s “financial position” would be negatively impacted because LF would have less retained earnings and a lower capital adequacy ratio’*,<sup>59</sup> the Full Court noted:

*‘there is no evidence to support a conclusion that LF suffered a detriment beyond that obvious and necessary consequence. LF was remunerated by way of management and administration fees. LF continued to be profitable, solvent and maintained its credit rating in each of the relevant years. Its capital needs grew because its business grew and not because it had been deprived of distributions by MHT. At the same time, the schemes had real economic and financial consequences to Vesta and Jupiter. These factors point away from a party having the requisite dominant purpose.’*<sup>60</sup>

7.20 In doing so, the Full Court undertook a detailed analysis between paragraphs [105] and [110] noting:

- (a) *The Commissioner’s submission is not accepted.*
- (b) *First, and most importantly, it discounts entirely the financial consequences to Vesta and Jupiter of the distributions made to them by MFGT which distributions would not have happened if MHT’s income had been distributed to LF...*
- (c) *Second, it fails to have regard to the totality of the circumstances including the fact that the Liberty group’s business was growing. Additional debt and equity capital were raised by the group from 2016 to support that growing business...*
- (d) *Third, the Commissioner’s contention that the non-exercise of the discretion to distribute income to LF adversely affected LF’s capital adequacy ratio and thereby put LF’s credit rating at risk is not supported by the evidence. The evidence was that LF’s credit rating improved from 2000 to 2014...*
- (e) *...*
- (f) *The evidence was that the non-payment of distributions to LF in the relevant years did not affect the solvency, profitability or credit rating of LF. LF had derived sufficient revenues to support its business needs in the relevant years. The changes in the financial position of LF as a result of the appellant’s exercise of its discretion as trustee of MHT to distribute no more than a small amount to LF as special unitholder in the relevant years do not support a conclusion that a party entered into or carried out any of the schemes for the dominant purpose of obtaining a tax benefit.*

<sup>57</sup> *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 at paragraphs [76] and [77]

<sup>58</sup> *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 at paragraph [97]

<sup>59</sup> *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 at paragraph [103]

<sup>60</sup> *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 at paragraph [113]



- 7.21 In rejecting the Commissioner's contention, the Full Court noted that adopting the ATO's position may have resulted in adversely affecting the financial position of other group members:

*Those same commercial outcomes would not have resulted if the MHT distributable income had been distributed to LF as the special unitholder. Contrary to the submissions of the Commissioner on appeal, it is not clear how LF would have been able to make equivalent distributions to Jupiter to reduce its indebtedness or to Vesta to enable it to increase its equity investment in MFGT and correspondingly increase MFGT's equity capital base.*<sup>61</sup>

## **Decision Impact Statement and other**

- 7.22 Despite the outcome in the Minerva Appeal, the Commissioner seeks to distinguish the facts of the case by noting that it involved a 'non-bank lender with an 'IPO ready' business structure'.
- 7.23 They confirm that the 'decision does not disturb the Commissioner's long-held view that schemes which include a trustee's exercise of discretion to distribute income can attract the operation of Part IVA. Further, whether Part IVA will apply to such a scheme will not be answered by the trustee's evidence of their purpose. It will depend on a consideration of the 8 factors collectively applied to the objective facts, to ascertain whether a party to the scheme had the requisite objective purpose that the taxpayer would obtain a tax benefit'.

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<sup>61</sup> *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 at paragraph [112]



## 8 Potential application of section 99A on an invalid trust distribution

8.1 Depending on the circumstances and the drafting of the trust distribution resolution, any of the following tax consequences may arise where an invalid trust distribution has been made:

- (a) the share of trust income may be reapportioned between the remaining beneficiaries of the distribution resolution;
- (b) the trustee of the trust may be assessed under section 99A ITAA 1936 at the top marginal rate; or
- (c) the 'default beneficiaries' of the trust may be assessed at their marginal rate.

8.2 For example, a distribution resolution that seeks to distribute income by distributing:

- (a) *the first \$20,000 to Person A;*
- (b) *the next \$20,000 to Person B; and*
- (c) *the last \$20,000 to Person C,*

may result in a failed distribution to Person B to be assessed against the default beneficiaries of the trust, as the phrasing suggests a 'cap' on the amount of income able to be received by Person A or Person C.

8.3 In contrast, where a distribution resolution seeks to distribute income as follows:

- (a) *the first \$20,000 to Person A;*
- (b) *the next \$20,000 to Person B; and*
- (c) *the balance to Person C,*

a failed distribution to Person B may result in such amount to be distributed to Person C.

8.4 Alternatively, where distributions are made on a proportionate basis, such as:

- (a) *30% to Person A;*
- (b) *30% to Person B; and*
- (c) *40% to Person C,*

either of the following interpretations may be adopted where the distribution to Person B fails:

- (d) Person B's entitlement is shared between Person A and Person C in proportion; or
- (e) Person B's entitlement is assessed against the default beneficiaries.

8.5 The drafting of the trust deed may again, impact the tax consequences, as some trust deed providers do not include default beneficiaries of income, which would result in any failed trust distributions to be assessed against the trustee under section 99A ITAA 1936 (at the top marginal rate).

8.6 The case of *The Trustee for Goldenville Family Trust A/C Xiangming Huang and Commissioner of Taxation (Taxation)* [2025] ARTA 1355 is a decision where the drafting of the deed resulted in income being distributed to the named 'default beneficiaries' following trust resolutions being determined as invalid.

8.7 Finally, in reducing the likelihood of having failed distribution resolutions, it is not recommended to distribute income with reference to the recipient's taxable income (known as a 'reverse engineered' distribution).





- 8.8 Such resolutions may contain drafting similar to the following:

*"An amount of trust income (to the maximum extent it is available) that would ensure that Harry's share of the net income of the trust as determined under section 97 of the ITAA 1936 does not exceed \$30,000;*

*An amount of trust income (to the maximum extent it is available) that would ensure that Eva's share of the net income of the trust as determined under section 97 of the ITAA 1936 does not exceed \$20,000; and*

*The balance (if any) to Chris."*

- 8.9 This option is not recommended in the context of the ATO's concerns outlined at issue 1 of TD 2012/22EC.
- 8.10 Specifically, there are potential arguments that such clauses may be challenged as being uncertain and ineffective. This is especially the case where elections and choices may be made after the trustee distribution resolution making it unreasonable to knowingly have any present entitlement at the date of the trust distribution resolution.
- 8.11 Such uncertainty may cause such appointments to fail by reason of uncertainty (but again, whether it would or not would be dependent on the facts and circumstance son a year by year basis).



## **9 Disclaimer**

- 9.1 This paper covers legal and technical issues in a general way. It is not designed to express opinions on specific cases. It is intended for information purposes only and should not be regarded as legal advice. Further advice should be obtained before taking action on any issue dealt with in this paper.

## **10 Contact details**

|             |                                       |
|-------------|---------------------------------------|
| Author      | Darius Hii, Director                  |
| Firm        | Chat Legal Pty Ltd ABN 64 621 391 553 |
| Direct line | 0403 923 374                          |
| Email       | darius@chatlegal.com.au               |