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# Taxation of Trusts – A Practical Guide for Junior Accountants

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### 1 Overview

- 1.1 It is expected that there will be over 1 million trusts in existence in Australia by 2022.<sup>1</sup> Whilst not all trusts will be discretionary in nature, a significant proportion (noting approximately 73.2% of trusts in existence in Australia in 2013/2014) are.<sup>2</sup>
- 1.2 With an Australian population as of June 2019 of 25,400,000,<sup>3</sup> there exists a trust for roughly every 25 individuals.
- 1.3 This emphasises the need for tax advisors to understand the taxation of trusts given the common and continued existence and use of discretionary trusts in current and prospective client circumstances.
- 1.4 This paper seeks to provide a practical guide for junior accountants who are tasked with navigating the minefield of making a trust distribution resolution.
- 1.5 In doing so, this paper asks the following key questions:
  - (a) **What** are we distributing?
  - (b) **Who** are we distributing to?
  - (c) **When** must we make the distribution?
  - (d) **Why** are we making the distribution?
  - (e) **How** can we make a distribution?
- 1.6 More specifically, this paper considers:
  - (a) understanding the difference between 'trust income', 'net income' and 'distributable income';
  - (b) issues to consider when streaming capital gains and franked distributions;
  - (c) accounting and tax issues for trust distributions;
  - (d) understanding the trust deed; and
  - (e) preparing distribution minutes.
- 1.7 Rather than explore each of the questions in extensive technical detail (as each of the questions in paragraph 1.5 is worthy of their own paper/s), this paper seeks to provide accountants with a broad overview of the various issues they must look out for; which will enable you to identify issues requiring further consideration.
- 1.8 The complementing presentation is intended to highlight practical tips to be wary of.
- 1.9 An example template trust distribution resolution is provided for in section 7.

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<sup>1</sup> The 2017 RMIT Report regarding 'Current issues with trusts and the tax system' at page 2 and <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/General-research/Current-issues-with-trusts-and-the-tax-system/>

<sup>2</sup> The 2017 RMIT Report regarding 'Current issues with trusts and the tax system' at page 20 provided statistics as to the breakdown of trusts in existence in Australia during the 2013-2014 financial year

<sup>3</sup> Australian Bureau of Statistics, 3101.0 - Australian Demographic Statistics, Jun 2019 – Released 19 December 2019 - <https://www.abs.gov.au/ausstats/abs@.nsf/lookup/3101.0Media%20Release1Jun%202019#:~:text=Australia%27s%20population%20grew%20by%201.5%20per%20cent%20during%20the%20year,annual%20increase%20of%20381%2C600%20people.%22>



## 2 What are we distributing?

2.1 From a tax advisor's perspective, it is crucial to understand:

- (a) what can be distributed from the trust; and
- (b) how are such distributed amounts taxed?

### ***Net income and distributable income (or trust income)***

2.2 Both questions are answered (on their face) under section 97 *Income Tax Assessment Act 1936* (Cth) (**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**).
- (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>4</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.
- (d) The taxpayer argued that they should only be taxed on the amount of Distributable Income actually distributed to them.

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<sup>4</sup> *Commissioner of Taxation v Phillip Bamford & Ors* [2010] HCA 10



- (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 on 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>5</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.
- (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.

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<sup>5</sup> See discussions in *Davis v FCT* 89 ATC 4377, *Richardson v FCT* 89 ATC 5098 and *Zetaforce v FCT* 98 ATC 4681



- (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>6</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 arises - and each beneficiary's 'adjusted Division 6 percentage' of the remaining 'income of the trust estate';

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<sup>6</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.



- (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.
- 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>7</sup>

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<sup>7</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.



- 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.
- 2.30 As a final note as to what is being distributed, where trust losses either exist or are required to be carried forward, care must be taken to ensure the trust loss rules of Schedule 2F ITAA 1936 are met and whether a family trust election should be made (which may be of use in additional circumstances; particularly where a discretionary trust wishes to distribute franking credits).<sup>8</sup>

### 3 Who are we distributing to?

- 3.1 Having understood ‘what’ is being distributed, it is important to know ‘who’ are being distributed to.
- 3.2 In relation to discretionary trusts, trustees are bound “*to consider at all times during which the trust is to continue whether or not they are to distribute any and if so what part of the fund, and, if so, to whom they should distribute*”.<sup>9</sup>
- 3.3 *Yazbek v Commissioner of Taxation* [2013] FCA 39 is a modern authority on what the ordinary legal meaning of being a “beneficiary” of a discretionary trust is:  
*I accept that the common use of “beneficiary” includes a person who is the object of a discretionary trust, including a person who has received no income or benefit from the trust in a given year – at [24]*
- 3.4 Just as the trust deed must be read to understand what Distributable Income is, such a deed will also contain who the beneficiaries of a discretionary trust are.
- 3.5 While there is no ‘one-size-fits-all’ approach, most trust deeds build a broad beneficiary class by firstly having persons specifically named (whether defined as a ‘Primary Beneficiary’, ‘Designated Beneficiary’ or some other term). Once defined, additional beneficiaries are included by reference of the Primary Beneficiary.
- 3.6 A standard beneficiary class can include the following persons and entities with reference to a Primary Beneficiary:
- (a) a Primary Beneficiary;
  - (b) a Spouse of the Primary Beneficiary;

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<sup>8</sup> Without a family trust election for a discretionary trust, franking credits attached to dividends paid are unlikely to be linked to a qualified person. Electing to be a family trust allows the trustee and beneficiaries of such a trust to benefit from franking credits.

<sup>9</sup> *Re Gestetner Settlement* [1953] Ch 672 at 688 per Harman J.





- (c) any Parent, Grand-Parent, brother or sister of the persons named in paragraphs (a) and (b) above;
  - (d) any Children, niece or nephew of the persons named in paragraphs (a) and (b) above;
  - (e) any Lineal Descendant of the persons named as paragraph (d) above;
  - (f) any Spouse of the persons named in paragraphs (a) to (e) above;
  - (g) the trustee of any trust which any Beneficiary is a member of a class of beneficiaries named in that trust, or holds units in that trust;
  - (h) any company that a Beneficiary, or this Trust holds any type of share or is a director in that company.
- 3.7 That said, the general class of beneficiaries cannot be assumed as every discretionary trust provider may adopt a different approach.
- 3.8 Some may restrict the general beneficiary class to: '*spouses, lineal descendants, parents, grand-parents and siblings*'.
- 3.9 Others may expand on the above general beneficiary class to include cousins and step-children.
- 3.10 All trust deeds, however, will include a class of persons who are specifically excluded from benefiting from the trust. Further, additional variation documents may have been prepared either increasing or reducing the beneficiary class for a variety of reasons. Common reasons for varying the class of beneficiaries can include:
- (a) Removing an ex-spouse as a beneficiary following a divorce/property settlement.
  - (b) Expanding a beneficiary class to include additional family members (such as an uncle or aunt).
  - (c) Restricting foreign persons from benefiting from the assets of the trust, where the trust is acquiring property.
  - (d) Restricting certain family members and entities from benefiting from a trust to ensure:
    - (i) separate family businesses are not grouped for payroll tax purposes; or
    - (ii) certain companies are not deemed to be a landholder for landholder duty purposes.
- 3.11 Where documents have been prepared varying the beneficiary class, steps should be taken to confirm such amendments have been validly made and effective pursuant to the terms of the trust deed.
- Excluded persons**
- 3.12 Every discretionary trust deed should include a provision excluding certain persons from benefiting.
- 3.13 Whilst most (if not all discretionary trusts) should specifically exclude the settlor and entities associated with the settlor,<sup>10</sup> some other excluded persons may include

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<sup>10</sup> This is required to ensure the revocable trust provisions of section 102 *Income Tax Assessment Act 1936* (Cth) do not apply. Such provisions operate to allow the Commissioner to assess the trustee of a trust on tax as if the settlor held such amounts in their name.



- (a) a person considered a 'notional settlor' – considered below; and
- (b) the trustee.

3.14 Further classes of persons may also be excluded, we the below sections provides brief considerations to be wary of.

***Exclusion of notional settlor***

3.15 A clause excluding a notional settlor may be worded as follows:

*'A person who has transferred property for other than full consideration in money or money's worth to the Trustee to be held as an addition to the Trust Fund (herein called 'the excluded persons'), or any corporation in which and the trustee of any settlement or trust in or under which any excluded person has an actual or contingent beneficial interest, so long as such interest continues, is excluded from the class of General Beneficiaries.'*

- 3.16 Such provision adopts a strict application of section 102 ITAA 1936 whereby persons who contributes to the settlement of assets in a trust are not to benefit from the trust. Such a clause would result in a person from being excluded from receiving distributions from a trust where amounts are gifted to the trust (or for under market-value) or interest-free loans are made.
- 3.17 Where trust deeds contains such provisions, care must be taken to determine the risk of invalid distributions having been made as it is common for beneficiaries of a trust to contribute to the accretion of a trust fund in the above manner.
- 3.18 Fortunately, such 'notional settlor' provisions are more commonly found in older deeds or templates and are less likely to be found in modern trust deeds.

***Exclusion of trustee***

- 3.19 It can be common to find provisions excluding a trustee from benefiting from a trust, regardless of age.
- 3.20 The modern reason for the inclusion of such provisions relates to section 54(3) of the *Duties Act 1997* (NSW) which provides a nominal duty exemption for a change of trustee to a trust where:

- (a) none of the continuing trustees remaining after the appointment of a new trustee are or can become a beneficiary under the trust;*
- (b) none of the trustees of the trust after the appointment of a new trustee are or can become a beneficiary under the trust; and*
- (c) the transfer is not part of a scheme for conferring an interest, in relation to the trust property, on a new trustee or any other person, whether as a beneficiary or otherwise, to the detriment of the beneficial interest or potential beneficial interest of any person.*

- 3.21 That is, such a provision is required in order to effect a change of trustee in a trust that holds dutiable property in New South Wales.
- 3.22 An older rationale for inclusion of such provision relates to reducing the conflict that a trustee my face in administering a trust by excluding them from benefiting.
- 3.23 Whilst such provisions made common specifically exclude a trustee in addition to a settlor, variations to the exclusion can include excluding a sole director of a company trustee.

***Exclusion of foreign persons***



- 3.24 It is common for trusts seeking to acquire property to now specifically exclude distributions to any 'foreign persons'.
- 3.25 This has been a result of the enforcing of the *Foreign Acquisitions and Takeovers Act 1975* (Cth) (**FATA**).
- 3.26 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).
- 3.27 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).
- 3.28 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.
- 3.29 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
  - (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'*.
- 3.30 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.
- 3.31 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.
- 3.32 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.
- 3.33 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>11</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.
- 3.34 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.

### ***Distributions from trust to trust***

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<sup>11</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.



- 3.35 All Australian jurisdictions except for South Australia have a statutory perpetuity period of 80 years. Some jurisdictions (namely Victoria, Tasmania, Western Australia and the Northern Territory) allows the common law perpetuity period to adopt 'a life in being plus 21 years' approach.
- 3.36 Generally, when trust to trust distributions are made, the vesting date of both trusts should be considered. Where the recipient has a vesting date which is later than the distributing trust, the risk that the rule against perpetuities is breached is a relevant issue.
- 3.37 It is noted that the case of *Nemesis Australia Pty Ltd (formerly Steve Hart Family Holdings Pty Ltd) v Commissioner of Taxation (2005) 225 ALR 576* confirmed that the 'wait and see rule' in section 210 of the *Property Law Act 1974 (Qld)*<sup>12</sup> can be relied on in a situation where a trust distributes to another trust with a later perpetuity date.
- 3.38 The 'wait and see' rule means the initial distribution will not be void when made and will not become void until such time as there is a failure to distribute out of the recipient trust before the vesting date of the original distributing trust.
- 3.39 Even if not a technical risk at law, some trust deeds include provisions restricting distributions to a trust that may vest at a later time.
- 3.40 The case of *Domazet v Jure Investments Pty Limited [2016] ACTSC 33* considered such a provision where the term 'General Beneficiaries' included the following:  
*'The trustee (in his capacity as such trustee) of any trust or settlement in which any Beneficiary has an interest whether absolute or contingent or by way of expectancy and whether liable to be defeated by the exercise of any power of appointment or revocation or to be diminished by the increase of the class to which that Beneficiary belongs which the Trustee may at any time and from time to time nominate in writing as a General Beneficiary and whether or not such trust or settlement is in existence at the date of this Deed but provided that the beneficial interest in property provided by such trust or settlement shall vest within the perpetuity period applicable to the trusts of this Deed'* (emphasis added)
- 3.41 As it were the case, the trustee of the trust wanted to distribute to a trust with a later vesting day; and a proper understanding of the law of perpetuities were crucial in determining that an amendment to the perpetuity period was required.

#### ***Distributions from trust to company***

- 3.42 Care must be taken when distributing to a company, and an unpaid present entitlement remains.
- 3.43 TR 2010/3 and PS LA 2010/4 outline the ATO's view that it is possible for a Division 7A loan to, in effect, arise from UPEs created after 16 December 2009.

#### ***Other potential exclusions***

- 3.44 Other potential exclusion provisions that may be found in a trust deed includes:
- (a) Restricting the beneficiary class to a test individual and their family following a family trust election. Such restriction may be embedded to ensure no family trust distribution tax is payable as it would not be a valid distribution to distribute outside a family group.
  - (b) Excluding persons (and their associates) on social securities from benefiting from the trust. The need for such provisions arises as assets and income of a trust may form

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<sup>12</sup> Other States have similar provisions in their respective legislation.



part of a person's asset and income tests where such a person can be deemed to control a trust (or potentially receive a distribution). Care must be taken where associates of such a person may fall within the potential persons receiving a distribution from the trust.

#### **4 When must we make a distribution?**

- 4.1 Trust distributions must be made by 30 June at the latest.
- 4.2 Where there are ineffectual appointments as at 30 June, such amounts are to be distributed to the default beneficiaries of the trust.<sup>13</sup>
- 4.3 Where the trust deed mandates an earlier period or date (for example, 5.00pm on 30 June), then such distribution resolutions must be made by that date/time.
- 4.4 Whether a trust distribution was made within the relevant period will ultimately come down to what can be proven.
- 4.5 Caution must be taken in the modern era as the 'backdating' of a trust distribution resolution may be identified from potential tell-signs such as being too precise as to distribution figures that could not have been known prior to 30 June, metadata of documents and correspondence evidencing a later signing of the resolution.

#### **5 Why are we making the distribution?**

- 5.1 While the answer to this question could simply be answered with two words: 'tax planning', greater thought should be had as to the impact a trust distribution may have on broader (and even future) tax planning opportunities.

##### ***Small business capital gains tax concessions***

- 5.2 Where small business capital gains tax concessions are considered to be utilised in the current income year or near future, thought should be had as to the impact of making trust distributions to persons.
- 5.3 Specifically:
  - (a) Will the trust distribution impact the entities that could be deemed to be '*connected with*' the trust for the purposes of the maximum net asset value test or turnover tests?
  - (b) Are certain trust distributions required to ensure a '*CGT concession stakeholder*' is present? Specifically, where distributions of income and capital are to be made, care must be taken to ensure appropriate proportion and complementing distributions from income and capital are made to ensure a greater small business participation percentage of 0 exists.
- 5.4 Such considerations are necessary as failure to adequately consider the impact could result in the inability to access quite generous concessions for the small business owner.

##### ***Trust losses***

- 5.5 Where a family trust election has not been made, care must be taken when making trust distributions to ensure the 'pattern of distribution' test is met.

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<sup>13</sup> *Commissioner of Taxation v Ramsden* [2005] FCAFC 39 at [68] referencing *Commissioner of Taxation v Marbray Nominees Pty Ltd* (1985) 81 FLR 280 and *East Fenchlet v Federal Commissioner of Taxation* (1989) 90 ALR 456



- 5.6 Failure for such a test to be considered could result in trust losses no longer being accessible.
- 5.7 To avoid such a scenario, it would be simplest for a family trust election to be made.

#### ***Division 7A***

- 5.8 Where distributions are made to corporate beneficiaries, such that either loans or unpaid present entitlements exists, thought should be had as to why, or whether such distributions are needed.
- 5.9 As highlighted above, there are additional layers of considerations to be had when distributing to a corporate beneficiary in an effort to juggle between managing the outstanding amount owed to the corporate beneficiary and ensuring sufficient liquidity.

#### ***Section 100A***

- 5.10 Before making a distribution to a beneficiary without truly intending ever truly pay such amount, care should be had as to section 100A ITAA 1936 (otherwise known as the reimbursement agreement).
- 5.11 Section 100A ITAA 1936 is designed to address tax avoidance where the Tax Office believes that a beneficiary who otherwise is presently entitled to trust income should be deemed not to be entitled, and instead the trustee should be subjected to penal taxation.
- 5.12 The focus of section 100A targeted arrangements where a beneficiary who was tax exempt or otherwise on a comparatively lower tax threshold was made presently entitled to a distribution. Steps were never made to fully pay out such a present entitlement to the beneficiary, but instead such sum would be gifted (or reimbursed) and distributed to the ultimate recipient (who was often on a higher marginal tax rate).
- 5.13 Reimbursement agreements are defined as any arrangement that allows the payment or transfer of property or the provision of services for any person other than the intended beneficiary for the purpose of reducing the tax liability of a beneficiary.
- 5.14 Importantly, section 100A does not apply to arrangements that are entered into in 'ordinary family or commercial dealings'. Unfortunately, such phrase is not defined in the tax legislation and clear examples of practical use have not been offered.
- 5.15 These provisions have come into light over the past few years with the ATO engaged in ongoing audits of private groups, often interviewing beneficiaries who have been made presently entitled but whom have not called upon such present entitlements.

## **6 How can we make a distribution?**

### ***Read the deed***

- 6.1 By this point in time, it should come at no surprise that how a distribution can be made is based on the terms of the trust deed.
- 6.2 While it would come at no surprise that the appropriate power must be checked, quoted and relied upon; steps must be taken to review each trust deed to confirm if any consents are required, or resolutions are required to be drafted in a particular manner.
- 6.3 There exist trust deeds that may require another person to consent to any distribution of income or capital of the trust.
- 6.4 An example of such a clause is as follows:



*“The Trustee may exercise any of the following powers where it has given the Appointor at least three day’s written notice of the exercise of the power, including specific details of how the power is to be exercised:...*

*...The power to Distribute Income or accumulate it.”*

- 6.5 Some alternatives may require at least 14 days written notice; whilst other may require the consent to be verified.
- 6.6 Other examples of stringent provisions may require the trustee to prepare a resolution in a particular way, such that if it does not include all the requested information, no valid resolution is made.

***Decisions made with ‘real and genuine consideration’***

- 6.7 Although discretionary trusts offer the trustee unfettered decision-making capability, such decisions must still be made within certain boundaries.
- 6.8 It is well documented that 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>14</sup> (subject to the rule of equity in *Saunders v Vautier*<sup>15</sup>); and
  - (b) can only compel the trustee to properly administer the trust.<sup>16</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>17</sup>*
- 6.9 Further, 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>18</sup>. This is generally due to Courts being reluctant to overturning 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>19</sup>
- 6.10 However, it is possible for a discretionary beneficiary to dispute a trustee’s decision are in circumstances where a trustee has failed to exercise their discretion ‘in good faith’.
- 6.11 ‘Bad faith’ can be made:
  - (a) where a trustee fails to consider the intention of the trust’s creator/settlor prior to making a decision;

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<sup>14</sup> *Pearson v Inland Revenue Commissioner* (1981) AC 753

<sup>15</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>16</sup> *Gartside v Inland Revenue Commissioners* (1986) AC 553

<sup>17</sup> *Gartside v Inland Revenue Commissioners* (1986) AC 553 at 606

<sup>18</sup> See G Thomas, *Thomas on Power* (1<sup>st</sup> edn), Sweet & Maxwell, London, 1998, at [6-204]

<sup>19</sup> *Re Beloved Wilkes Charity* (1851) 3 Mac & G 440; 45 ER 330 at 333



- (b) where a trustee is deliberately deceptive for their personal gain or decisions are exercised with dishonesty; or
  - (c) where a trustee fails to give real and genuine consideration to the exercise of their discretions.
- 6.12 The recent Victorian case of *Callus v KB Investments* [2020] VCC 135 is an example where 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'.
- 6.13 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.
- 6.14 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.
- 6.15 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.
- 6.16 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.
- 6.17 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.
  - (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.
- 6.18 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);
- (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);
- (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); 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.

6.19 In contrast, the decision of *Ying Mui & Ors v Frank Kiang Ngan Hoh & Ors* (No 6) [2017] VSC 730 was an example where the Court examined the distribution determinations by the trustee of a discretionary trust and found that they had been made in bad faith and for an improper purpose and ordered that the funds were held on constructive trust for a particular beneficiary who did not receive discretionary distributions.



## 7 Example template trust distribution minute

### Guidelines for use

- 1 The template distribution resolution is provided as a guide for the potential structure of a trust distribution minute. The trust deed clause numbers referred to in this template should be amended depending on the terms of the trust deed for the relevant trust..
- 2 The relevant resolutions should be copied into an appropriately drafted resolution or minute of the trustee. Where the trustee is a company, the resolution should be recorded in a minute of the meeting of directors at which the resolution was made or a circular resolution – whichever approach is adopted it must also comply with the company’s constitution. Where the trustee is one or more individuals, a written resolution should be signed by all trustees and stored with the trust deed and financial statements.
- 3 It is recommended that the trustee obtain specific advice to ensure that the distribution resolutions are appropriate in each year and that all beneficiaries receiving distributions fall within the relevant beneficiary definitions in the deed.
- 4 Certain resolutions should be deleted depending on whether streaming of income or capital distributions are intended to be made.
- 5 Ultimately no template resolution is suitable as a standard document. Each client’s circumstances and terms of the trust deed may impact the suitability of which provisions are used or not.
- 6 The template **does not** include an option to distribute income with reference to the recipient’s taxable income (known as a ‘reverse engineered’ distribution). This option is not recommended in the context of the ATO’s concerns outlined at issue 1 of TD 2012/22EC.
- 7 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 We recommend that beneficiary entitlements be expressed as a percentage, rather than a specified sum. However, where it is resolved to distribute specific amounts, care should be taken to ensure that all amounts have been distributed as the automatic default provisions in the deed will apply to any undistributed amounts.
- 9 The resolution is crafted to ensure that Distributable Income includes gross capital gains, not the discount gains. For this to be effective, the trust accounts must be consistent with the resolution (i.e. including the gross gain in the distributed amount).

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#### 1 Overview

- 1.1 This document records the resolution to determine the Distributable Income of the Trust for the period from 1 July \*\*\*\* to 30 June \*\*\*\* (**Relevant Period**), pursuant to the relevant powers under the trust deed for the Trust.
- 1.2 This document records the resolution to determine the manner in which the Distributable Income for the Relevant Period is to be distributed to the beneficiaries of the Trust.



- 1.3 This document records the resolution to determine the manner in which the Capital of the Trust Fund is to be distributed to the beneficiaries of the Trust.
- 1.4 The Trustee has the power under clause 3.3 to hold the Distributable Income on trust absolutely for the beneficiaries (or any one or more of them to the exclusion of the other beneficiaries) in the proportions that the Trustee, with an absolute discretion, decides.
- 1.5 The Trustee has the power under clause 4.1 to hold the Capital of the Trust Fund or any part of it on trust for the benefit of any one or more of the beneficiaries in the proportions that the Trustee, with an absolute discretion, decides.
- 1.6 The Trustee's resolutions in relation to the matters above are set out below.

## 2 Appointment of beneficiaries

### *Resolution*

- 2.1 Pursuant to clause 2, the Trustee appoints the following persons/entities as beneficiaries of the Trust:

[#Insert, and tailor clause based on power under the trust deed]

## 3 Beneficiaries

- 3.1 The Trustee confirms that the following intended recipients of this trust distribution resolution are valid beneficiaries of the Trust as follows:

[#Insert beneficiary] – [#confirm how they are a beneficiary with reference to the definitions of Primary Beneficiaries, Secondary Beneficiaries or Tertiary Beneficiaries];

[#Insert additional beneficiaries].

## 4 Determination of Distributable Income

### *Resolution*

- 4.1 Pursuant to the terms of the Trust deed including the power of the trustee to classify such Distributable Income as a separate category of income as the Trustee decides at clause 3, it is resolved that the Distributable Income of the Trust includes such amounts equal to the net income of the Trust as defined in section 95 Income Tax Assessment Act 1997 (excluding notional amounts) in addition to the following, whether derived directly or indirectly (including by entitlement through other trusts):

- (a) all franked dividends received by the Trust during the Relevant Period, and that the franked dividends be identified as a separate category of income;
- (b) all realised capital gains (including any discount capital gain under subdivision 115-A *Income Tax Assessment Act 1997* (Cth), and such other capital gains not otherwise taxable) received by the Trust during the Relevant Period and that the capital gains be identified as a separate category of income.

- 4.2 In particular:

- (a) all franked dividends received by the Trust during the Relevant Period will be included in the Distributable Income of the Trust;
- (b) pursuant to clause 3.6(a), such franked dividends be identified as a separate category of income;



- (c) pursuant to clause 3.6(a), have all franked dividends, whether derived directly or indirectly (e.g. by entitlement through other trusts), be treated as one class of income
- (d) pursuant to clause 3.6(b), have all outgoings incurred and directly relevant to a franked distribution allocated against that franked distribution.

4.3 In particular:

- (a) all realised capital gains (including any discount capital gain under subdivision 115-A *Income Tax Assessment Act 1997* (Cth), and such other capital gains not otherwise taxable) received by the Trust during the Relevant Period and that the capital gains be included in the Distributable Income of the Trust;
- (b) pursuant to clause 3.6(a), have such capital gains identified as a separate category of income;
- (c) pursuant to clause 3.6(b), have the capital gains calculated net of the capital expenses and outgoings relating to those capital gains.

4.4 Pursuant to clause 3.6(c), have prior year losses recoup as follows:

- (a) **[#confirm]**.

4.5 Pursuant to clause 3.6(c), does not include the recoupment the following losses from prior years:

- (a) **[#confirm]**.

## 5 Specific entitlement to franked dividends

### **Resolution**

5.1 Pursuant to clause 3.6, it is resolved to distribute the Distributable Income of the Trust comprising franked dividends to:

- (a) **[#insert]% to [#insert beneficiary]**; and
- (b) **[#insert]% to [#insert beneficiary]**.

Or:

- (c) **[\$[#insert amount] to [#insert beneficiary]**; and
- (d) **[\$[#insert amount] to [#insert beneficiary]**.

5.2 It is resolved to sign any document, or take any step or action necessary, to effect the distributions resolved under this section.

## 6 Specific entitlement to capital gains

### **Resolution**

6.1 Pursuant to clause 3.6, it is resolved to distribute the Distributable Income of the Trust comprising capital gains **[#optional: relating to the disposal of [#insert description of asset] or manner in which the gain arose, if it is flowing from another entity]**, net of specified current and prior year capital losses, to:

- (a) **[#insert]% to [#insert beneficiary]**; and
- (b) **[#insert]% to [#insert beneficiary]**.

Or:



- (c) \$[#insert amount] to [#insert beneficiary]; and
- (d) \$[#insert amount] to [#insert beneficiary].

6.2 It is resolved to sign any document, or take any step or action necessary, to effect the distributions resolved under this section.

## 7 Accumulation of income

### *Resolution*

7.1 Pursuant to clause 3.2 it is resolved to accumulate \$[#amount] of the Distributable Income of the Trust to form part of the Capital of the Trust Fund.

## 8 Distribution of income

### *[#Option 1 - percentages]Resolution*

- 8.1 Pursuant to clause 3.3 it is resolved to distribute the Distributable Income remaining after the preceding distributions to:
- (a) the first [#insert]% to [#insert beneficiary];
  - (b) the next [#insert]% to [#insert beneficiary]; and
  - (c) the remaining [#insert]% to [#insert beneficiary].

### *[#Option 2 - amounts]Resolution*

- 8.2 Pursuant to clause 3.3 it is resolved to distribute the Distributable Income remaining after the preceding distributions to:
- (a) \$[#insert amount];
  - (b) \$[#insert amount]; and
  - (c) any Distributable Income remaining undistributed by the preceding distributions to [#insert beneficiary].

## 9 Distribution of capital

- 9.1 Pursuant to clause 4.1 it is resolved to distribute the following Capital of the Trust Fund as follows:
- (a) [#insert]% to [#insert beneficiary]; and
  - (b) [#insert]% to [#insert beneficiary].
- Or:
- (c) \$[#insert amount] to [#insert beneficiary]; and
  - (a) \$[#insert amount] to [#insert beneficiary].



## **8 Acknowledgement**

- 8.1 The author acknowledges that parts of this paper was a structured from an earlier reiteration of the topic and wishes to acknowledge the assistance of Dung Lam (now of West Garbutt) who provided feedback and guidance to the author at the time, but notes any errors in this paper are the author's own.

## **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**

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