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Taxation of Trusts – A Practical Guide for Junior Accountants

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Information provided is general in nature; precise application depends on specific circumstances

Overview

- **What** are we distributing?
- **Who** are we distributing to?
- **When** must we make the distribution?
- **Why** are we making the distribution?
- **How** can we make a distribution?

Relevant for accountants

- 'Trust income', 'net income' and distributable income'
- Streaming capital gains and franked distributions
- Accounting and tax issues for trust distributions
- Understanding the trust deed
- Preparing distribution minutes

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What are we distributing?

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Key legislative provision

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

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

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

- Section 97 ITAA 1936

In plain English

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

Issues arising

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

Bamford

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

Bamford

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

Distributable Income as anything?

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

Streaming

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

Specifically entitled

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

Many faces of Distributable Income

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

Capital gains specific entitlement

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

Loss position

- Appreciate the trust loss rules
- *Upton v Brown* – prior losses must be recouped against current year Distributable Income
- If no Distributable Income, then cannot stream capital gains or franked distributions
- Need for trust deed to have a power to choose not to utilise prior year losses

Who are we distributing to?

Beneficiaries

- Built around naming a few people and building a family around them
- Other trusts, companies and charities
- Excluded class of beneficiaries

Checking definitions

- Some beneficiary relations require clarity in the definitions
- 'Spouse':
  - Includes defacto, same-sex or ex-spouse?
- 'Child':
  - Includes adopted or step?
- Just how wide is the beneficiary class?
  - Spouse, parent, grand-parent, child, niece, nephew, lineal descendants, aunt and uncle
  - spouses, lineal descendants, parents, grand-parents and siblings

Whose out?

- Settlor
- Notional settlor
- Trustee
- Foreign persons
- Trusts which vest at a later date
- Persons who do not fall within a 'family group' under a family trust election
- Persons receiving social securities and their associates

Examples

Settlor and Trustee excluded

"It is hereby declared that the Settlor and his estate, the Trustee and any former Trustee and any corporation or Trust in which the Settlor or his estate or the Trustee or any former Trustee has any actual or contingent beneficial interest are specifically excluded from all or any benefits whatsoever under this Trust"

Notional Settlor excluded

'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.

Examples

Trusts vesting at a later date excluded

'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'

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Examples

Persons on social securities benefits excluded

…the Trust Fund and the income thereof shall be held to the entire exclusion of and of any benefit to any person who is at that time a recipient of a means-tested Centrelink and/or Veterans' Affairs income support payment and their Associate (as the term "Associate" is defined under the Corporations Act) whether by contract or otherwise howsoever

Foreign persons excluded

No distribution of capital or income of the Trust of or derived from Australian urban land shall be made in favour of any Beneficiary or class of Beneficiary excluded from acquiring an interest in Australian urban land under the Foreign Acquisitions and Takeovers Act 1975 and Foreign Acquisition and Takeovers Regulation 1989 without the prior approval of the Foreign Investment Review Board

When must we make a distribution?

Timing is everything

- The earlier of
  - 30 June
  - The date and time stated in the trust deed
- Evidence and the modern era

Why are we making the distribution?

Bigger picture considerations

- Small business capital gains tax concessions – when trying to satisfy concessions
- Trust losses – pattern of distribution test
- Division 7A – issues when not paying out the distribution
- Section 100A – issues when 'using' others' lower tax rate; anti-avoidance provisions

How can we make a distribution?

Read the deed in its entirety

- Follow the deed including any consents or requirements of form of the resolution
- E.g.

> *"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."*

Real and genuine consideration

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

Constructing the resolution

Example 1

- ‘Income’ equal to $100,000
- ‘Capital’ equal to $1,000,000
- Income beneficiaries:
  - Husband - $50,000
  - Mother - $50,000
- Capital beneficiary – 100% to Wife

Example 1A

- What are we distributing?
  - 1(m) *Income* and *income of the Trust Fund* shall mean the net income of the Trust Fund as calculated under the Tax Act, but including all of the Capital Gain, unless the Trustee exercises its discretion under clause 10
  - 1(c) *Capital Gain* means net capital gains according to ordinary concepts
  - 10 The Trustee shall have power to determine in its absolute discretion whether any receipt, profit or gain or payment, loss or outgoing or any sum of money or investment, or notional amount, in any Financial Year, or any revenue or capital loss carried forward from a prior Financial Year, is or is not to be treated as being on income or capital account
- Issues?
  - Ambiguity(?)
  - Do nothing, the 'discounted' capital gain not included income → need to do a separate capital distribution
  - Exercising discretion to classify capital gain on income account → just income distribution (although ambiguity if effective)

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Example 1B

- What are we distributing?
  - 1.4 "the Income" means that amount derived in accordance with Section 95 of the Income Tax Assessment Act 1936-1975 (as amended from time to time) unless the Trustee shall on or before the last day of the year of income declare in writing that the provisions of this sub-clause shall not apply in relation thereto and in the event of any such declaration in relation thereto and in the event of any such declaration being made "the Income" means the income produced from the investment of the Trust Fund and/or from the property thereof.
- Income can either:
  - Include the assessable capital gain (per section 95)
  - If not, does not include any capital gain
  - There is no discretion to determine what is on income account

Example 2

- Don't assume every deed has a schedule
- Trust resolution wording:

  1.1 The 'Primary Beneficiaries' of the Trust are relevant defined in the Schedule to the Trust Deed as are follows:

- Trust deed clause relating to Beneficiaries:

  1.1(b) Beneficiary or Beneficiaries shall mean and include:

  (i) Named Person

  (ii) the spouse from time to time of Named Person

  (iii) any issue (including children and remoter issue of Named Person

  (iv) any spouse of any Beneficiary falling within the class of Beneficiary referred to in clause 1(b)(iii)

  (v) any relative of Named Person;…

Constructing a minute

- Confirm the year of the resolution

*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.*

- Confirm if the resolution relates to one or both of income and capital

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.

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.

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.

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.

Constructing a minute

- Need to appoint any beneficiaries?

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

- Ideally confirm the beneficiaries in receipt of distribution:

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

Constructing a minute

- Determine what Distributable Income
  - Confirm what is income (if possible)
  - Alternatively, confirm if section 95 or ordinary concepts apply

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.

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- Consider if any income to be accumulated
- Consider if losses are to be recouped (or carried forward, if possible)
- Consider if franked distributions or capital gains are to held as a separate class of income (if the deed permits)

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.

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- Distribution of income (general class) or classes of income (for franked dividends/capital gains) or capital distribution

[#Option 1 - percentages]

(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]

(a) $[#insert amount];

(b) $[#insert amount]; and

(c) any Distributable Income remaining undistributed by the preceding distributions to [#insert beneficiary].

Take-outs

- What:
  - Beware when intending to stream capital gains or dividends
  - Consider issues arising where losses or notional amounts are relevant
- Who:
  - Know who are and are not beneficiaries
- When:
  - Get it done in time
- Why:
  - Just ask 'why'; take a holistic approach
- How:
  - Follow the required procedures

Take-outs

- Read the deed
  - Refer to the correct powers and clauses
- Start putting together a checklist

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Questions?

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