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# Trust Income Distributions and the Role of the Deed: Getting It Right

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## Trust Income Distributions and the Role of the Deed: Getting It Right

### 1 Overview

- 1.1 There's a lot to consider these days when it comes to distributing the net income of a trust and there is no shortage of Australian Taxation Office (**ATO**) guidance material on the tax consequences that can arise from those distributions.
- 1.2 However, is the relevant trust deed in each case also being given the required attention to ensure the distribution is valid? This session explores the topic, including:
  - (a) How the contents of a trustee company's constitution interacts with a trust's distribution requirements.
  - (b) How the distribution of trust income is impacted by:
    - (i) the various income definitions that can be used in a deed;
    - (ii) whether a deed includes "streaming" clauses and how expenses are treated that relate to the streamed income;
    - (iii) franking credits.
  - (c) Determining if the beneficiaries being allocated income or capital are eligible both:
    - (i) under the deed, including when there are foreign beneficiary exclusions for state and territory tax and duty purposes, and
    - (ii) if a family trust election or interposed entity election is in place.
  - (d) Tips on preparing distributions that involve non-assessable capital gains based on differing trustee clauses.
  - (e) Acceptable documentation that supports the timing, content, and decision-making process for a trust distribution.
  - (f) How deeds differ with the documenting of distributions and the Corporations Law requirements for completing, filing and retaining.
  - (g) Consequences of an invalid distribution of trust income.
- 1.3 Practical examples of trust distributions based on various differing trust deed clauses will be provided during the presentation of this topic.
- 1.4 References to legislation in this paper has been defined as follows:
  - (a) *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**).
  - (b) *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**).
  - (c) *Duties Act 2001* (Qld) (**QLD Duties Act**).
  - (d) *Duties Act 1997* (NSW) (**NSW Duties Act**).
  - (e) *Duties Act 2000* (Vic) (**VIC Duties Act**).
  - (f) *Stamp Duties Act 1923* (SA) (**SA Duties Act**).
  - (g) *Duties Act 2008* (WA) (**WA Duties Act**).



## 2 Trustee company constitution and trust distribution requirements

- 2.1 Whilst trust deeds generally share the spotlight in the context of undertaking trust distributions; it is still important to appreciate the role of a company trustee's constitution.
- 2.2 Just like a trust is governed by its trust deed, a company is governed by its own constitution; or where no constitution has been adopted, the replaceable rules under *Corporations Act 2001* (Cth) (or a combination of both).
- 2.3 It is important to ensure any rules and processes outlined in a company's constitution are followed to ensure that any subsequent trust resolution is valid.
- 2.4 Potential provisions of concern may include (but not always) ensuring:
  - (a) If a trust distribution is to be agreed by way of minute of meetings; that any notice periods are complied with, and appropriate documentation (such as a notice of minute of meetings) are prepared and retained with the company records.
  - (b) Director resolutions requiring all directors to sign, are executed by all directors by the required effective date, noting that the resolution is effective upon the last of the director to sign the document.
  - (c) Any director decision-making provisions are complied with. Some clients may have bespoke company constitution provisions requiring board decisions to be made in a particular manner, or with particular persons in the majority.
  - (d) Any director decisions/quorums are met. Older company governing documents (known as a 'memorandum and articles of association') may require the company to have two directors, thereby making any single director resolutions invalid. Where a company governing document include such provision; thought should be had in updating the document to a modern company constitution.
- 2.5 As will be outlined below, following the stated rules and procedures are important in mitigating any potential dispute risk.



### 3 Distributing trust income

3.1 In determining how to distribute income from a trust, it is important to consider:

- (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)***

3.2 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:*

- (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”*

3.3 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).

3.4 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.

3.5 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>1</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

3.6 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>2</sup>

3.7 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.

3.8 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>2</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***

- 3.9 The outcome of *Bamford* did force a change in law regarding the taxation of trusts.
- 3.10 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.
- 3.11 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.
- 3.12 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.
- 3.13 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 arises - and each beneficiary's 'adjusted Division 6 percentage' of the remaining 'income of the trust estate';

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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.



- (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.
- 3.14 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.
- 3.15 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.
- 3.16 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.
- 3.17 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.

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

- 3.18 Back to our initial question in knowing what can be distributed from the income.
- 3.19 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.
- 3.20 As held in *Bamford*, the terms of a trust deed determine what Distributable Income is.
- 3.21 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).
- 3.22 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.
- 3.23 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.
- 3.24 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.
- 3.25 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.
- 3.26 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>
- 3.27 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

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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.



separate classes of income and determine whether or not to offset prior year trust losses against current year income.

- 3.28 Later sections will consider the options available in distributing non-assessable capital gains depending on how Distributable Income is defined.

**Trust losses**

- 3.29 An example for the need to have a level of flexibility in a trust's income distribution power may relate to a scenario where a trust holds existing losses.
- 3.30 Later sections of this paper will briefly consider the requirements under various tax provisions to utilise trust losses in a discretionary trust.
- 3.31 As with the need to identify what distributable income is, a trust deed must be reviewed to confirm whether the trustee has the power to determine whether or not to offset prior year trust losses.
- 3.32 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.
- 3.33 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 distributable income to nil but there is still positive net taxable income for the trust.
- 3.34 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).
- 3.35 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) Trust derives a capital gain equal to \$50,000.
  - (d) Income of the trust is defined in the deed as 'income according to ordinary accounting principles'.
  - (e) There is no provision in the trust deed that enables the trustee with the power not to offset prior year trust losses.
  - (f) There is no provision in the trust deed that enables the trust to redefine income of the trust to include capital gains as part of distributable income.
  - (g) A's carry forward losses exceed the income derived from income (according to ordinary concepts), there is no distributable income of the trust.
  - (h) 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.



## 4 Identifying eligible beneficiaries

- 4.1 Perhaps the most important reason to review the trust deed is to know who is a beneficiary of the trust.
- 4.2 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.
- 4.3 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;*
  - (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.*
- 4.4 That said, the general class of beneficiaries cannot be assumed as every discretionary trust provider may adopt a different approach.
- 4.5 Some may restrict the general beneficiary class to: '*spouses, lineal descendants, parents, grand-parents and siblings*'.
- 4.6 Others may expand on the above general beneficiary class to include cousins and step-children.
- 4.7 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.
- 4.8 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.



- 4.9 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

- 4.10 Every discretionary trust deed should include a provision excluding certain persons from benefiting.
- 4.11 Whilst most (if not all discretionary trusts) should specifically exclude the settlor and entities associated with the settlor,<sup>5</sup> some other excluded persons may include
- (a) a person considered a 'notional settlor' – considered below; and
  - (b) the trustee.
- 4.12 Further classes of persons may also be excluded, and the below provides brief considerations of provisions to be wary of.

### **Exclusion of notional settlor**

- 4.13 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.'*
- 4.14 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.
- 4.15 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.
- 4.16 Further, where trust deeds refer to the term 'notional settlor' but does not define who that may be, care should be taken to understand who this may include.
- 4.17 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**

- 4.18 It can be common to find provisions excluding a trustee from benefiting from a trust, regardless of age.
- 4.19 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:

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<sup>5</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) 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.*

4.20 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.

4.21 An older rationale for inclusion of such provision relates to reducing the conflict that a trustee may face in administering a trust by excluding them from benefiting.

4.22 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***

4.23 It is common for trusts seeking to acquire property to specifically exclude distributions to any 'foreign persons'.

4.24 This has been a result of the enforcing of the *Foreign Acquisitions and Takeovers Act 1975* (Cth) (**FATA**).

4.25 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).

4.26 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).

4.27 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.

4.28 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'.*

4.29 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.

4.30 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.



- 4.31 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.
- 4.32 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>6</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.
- 4.33 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.
- 4.34 Care should be taken with reviewing the wording of any foreign person exclusion. This is because:
- (a) A blanket exclusion of a 'foreign person' under the definition in FATA from being a beneficiary will include an Australian citizen who is living overseas.<sup>7</sup>
  - (b) This means that the trust would be unable to make distributions to an Australian citizen who is a non-tax resident.
  - (c) Alternative foreign exclusion wording may refer to State or Territory stamp duty or land tax legislation instead of FATA noting that different State and Territory legislation have different wording for who is a 'foreign person'.
  - (d) Further, rather than a blanket exclusion of a 'foreign person' as a beneficiary; the provision may be worded to restrict the trustee from making any distribution that may cause the trust to be required to make an application to the Foreign Investment Review Board.

***Foreign person as defined by State or Territory legislation***

- 4.35 As outlined above, each State or Territory may define a foreign person slightly differently from FATA.
- 4.36 In New South Wales under the NSW Duties Act:
- (a) **Surcharge purchaser duty** may apply when a foreign person acquires residential-related property;<sup>8</sup>
  - (b) This aligns with the Qld Duties Act in that the additional duty only applies with respect to residential properties; and
  - (c) A foreign person is defined in section 104J of NSW Duties Act to mean a person who is a foreign person under FATA with certain modifications confirming that an Australian citizen; and a New Zealand citizen holding a special category visa under section 32 of the *Migration Act 1958* (Cth) would be considered as residing in Australia.

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<sup>6</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.

<sup>7</sup> Australian Government, The Treasury, Guidance Note 2, page 5:  
<https://foreigninvestment.gov.au/sites/foreigninvestment.gov.au/files/2025-03/guidance-note-2-key-concepts-v3.pdf> – accessed 09 January 2026

<sup>8</sup> Section 104L of NSW Duties Act.



- 4.37 In Victoria under the VIC Duties Act:
- (a) Additional duty is chargeable on residential property transferred to a foreign purchaser;<sup>9</sup>
  - (b) A foreign purchaser is defined in section 3(a) of VIC Duties Act to include the trustee of a foreign trust;
  - (c) A foreign trust is defined to mean a trust in which one or more 'foreigners' hold a substantial interest;
  - (d) A substantial interest is defined in section 3B of VIC Duties Act to be either:
    - (i) A beneficial interest of more than 50% of the capital of the estate of the trust; or
    - (ii) If the Commissioner makes a determination under section 3D of VIC Duties Act that a person has sufficient practical influence over the trust;
  - (e) Section 3B(2) of VIC Duties Act includes a similar deeming provision as found in the FATA, in relation to the interpretation of whether a discretionary beneficiary over the capital of the trust estate has the maximum percentage possible of what they can receive.<sup>10</sup>
- 4.38 In addition to the above legislative definitions, both New South Wales and Victorian revenue authorities have adopted approaches where discretionary trust deeds must explicitly exclude foreigners as beneficiaries of the discretionary trust as the only way to ensure a discretionary trust is not 'foreign'. In the case of New South Wales, such an approach was legislated requiring the exclusion to be irrevocable and there have been cases critiquing exclusion wording that was only operational where the trust held relevant residential properties.
- 4.39 In Queensland under the QLD Duties Act:
- (a) AFAD is chargeable where a foreign person acquires an interest in certain residential property.
  - (b) A foreign person includes a foreign trust.
  - (c) A foreign trust is defined to mean a trust in which 50% of the trust interest in the trust are foreign interests.
  - (d) A trust interest does not consider the general beneficiary class but considers who the taker-in-default of the trust are (more colloquially known as the 'default beneficiaries') – section 57 of QLD Duties Act.
- 4.40 Western Australia and South Australia also imposes surcharge stamp duty on foreigners acquiring residential land.
- 4.41 Interestingly:

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<sup>9</sup> Section 28A of VIC Duties Act.

<sup>10</sup> *'If, under the terms of a trust, a trustee has a power or discretion as to the distribution of the capital of the trust estate to a person or a member of a class of person, any such person is taken to have a beneficial interest in the maximum percentage of the capital of the trust estate that the trustee is empowered to distribute to that person'* – Section 3B(2) of VIC Duties Act.



- (a) The SA Duties Act adopts a different approach on when a discretionary trust is a foreign trust.<sup>11</sup> Specifically, if a foreign person is any of the following roles in a discretionary trust, the trust will be a foreign trust:
  - (i) A trustee;
  - (ii) A person who has the power to appoint under the trust (i.e. the appointor/principal power);
  - (iii) An identified object under the trust (i.e. a named beneficiary); or
  - (iv) A person who takes capital of the trust property in default; and
- (b) The WA Duties Act also offers no consistent definition on what it means to be a foreign trust by stating that a discretionary trust is a foreign trust if:<sup>12</sup>
  - (i) It is controlled by a foreign person (being a person in a position to influence, either directly or indirectly, the vesting of the whole or any part of the capital of the trust fund, or of the whole or any part of the income of the trust property); or
  - (ii) One or more foreign persons (together with their associates) are takers in default and together hold at least a 50% interest in the discretionary trust.

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

- 4.42 All Australian jurisdictions except for South Australia and Queensland have a statutory perpetuity period of 80 years (Queensland has a statutory perpetuity period of 125 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.
- 4.43 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.
- 4.44 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>13</sup> can be relied on in a situation where a trust distributes to another trust with a later perpetuity date.
- 4.45 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.
- 4.46 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.
- 4.47 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*

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<sup>11</sup> Section 2(14)(b) of SA Duties Act

<sup>12</sup> Section 205D of WA Duties Act.

<sup>13</sup> Other States have similar provisions in their respective legislation.



*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)*

- 4.48 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.

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

- 4.49 Other potential exclusion provisions that may be found in a trust deed includes:
- (a) 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 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.
  - (b) 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.

### **Family trust elections and distributing to beneficiaries**

- 4.50 Not all trust deeds may include a clause restricting a beneficiary class following the making of a family trust election.
- 4.51 This means that it is technically possible for a trust that has made a family trust election to make a trust distribution outside a family group.
- 4.52 Where a trust makes a distribution outside a family group after having made a family trust election, Family Trust Distribution Tax will be payable on that distribution. Family trust distribution tax is a 47% tax, payable by a trustee or any director of a corporate trustee.
- 4.53 It is appropriate to consider the reason behind making a family trust election, and the subsequent effect it will have on future distributions.
- 4.54 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.
- 4.55 Schedule 2F of ITAA 1936 contains the relevant legislation regarding the ability to utilise trust losses.
- 4.56 Due to the difficulty of a discretionary trust to utilise existing tax losses via a distribution from another discretionary trust, it is common for a family trust election to be made in favour of the trust.



- 4.57 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.
- 4.58 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).
- 4.59 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.
- 4.60 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***

- 4.61 Subdivision 272-D ITAA 1936 outlines the circumstances in which a family trust election can be made over a trust.
- 4.62 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.

4.63 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**

4.64 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.

4.65 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.

4.66 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.

4.67 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.
- 4.68 Selecting an appropriate Test Individual will allow for the Trust to receive distributions from 'external trusts' as the Income Injection Test will be met.
- 4.69 Section 270-10 ITAA 1936 outlines the Income Injection Test.
- 4.70 At it's simplest, the test will be failed where a family outsider of the trust provides a benefit to the trust as part of a scheme.
- 4.71 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***
- 4.72 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.
- 4.73 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.
- 4.74 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.
- 4.75 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.
- 4.76 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



## 5 Preparing distributions involving non-assessable capital gains

- 5.1 As outlined above, the definition of what is Distributable Income under the trust deed will impact how non-assessable capital gains may be distributed to beneficiaries.
- 5.2 Consider the following scenario:
- (a) Trust has made in a financial year:
    - (i) \$100,000 rental income; and
    - (ii) \$1,000,000 capital gain.
  - (b) It is proposed to distribute the rental income to Husband and Wife (for their day-to-day living expenses) and the capital gains to the Husband's Father (who has made difficult investment decisions during his lifetime).
- 5.3 Depending on the definition of Distributable Income in the trust deed, the following distributions may be required.
- 5.4 Where Distributable Income equals **ordinary income**, a capital distribution would also need to be drafted in addition to a general income resolution to ensure the capital gain can be streamed to the Father.
- 5.5 Where Distributable Income equals **section 95 income**, then in addition to the general income resolution, appropriate resolutions would be required to:
- (a) identify and classify such of the capital gain that forms part of Distributable Income as a separate class of income;
  - (b) distribute the separate class of income relating to the capital gain to the Father; and
  - (c) a distribution of such capital gain that does not form part of Distributable Income must be made to the Father.
- Care may be taken when drafting such resolutions to relate such capital proceeds attributable to a capital gains tax event for clarity.
- 5.6 Where Distributable Income equals **such amount as the trustee determines**, then the trustee has the flexibility to determine either of the above approaches, or potentially redefining Distributable Income to include section 95 income in addition to any non-assessable capital gains before appropriate resolutions being prepared to:
- (a) identify and classify the capital gain as a separate class of income; and
  - (b) distribute the separate class of income relating to the capital gain to the Father.

## Small business capital gains tax concessions and non-assessable capital gains

- 5.7 Where clients operate a business that may benefit from the small business CGT concessions, due care must be had in the years leading up to any potential sale for the purposes of meeting any potential 'maximum net asset value' test or 'turnover' test.
- 5.8 Of relevance in relation to the distribution of non-assessable capital gains, care should be taken as the manner in which a distribution is made may impact the availability to meet the significant individual test where a trust owns shares in a trading company (or units in a trading unit trust).

### ***Trust distributions impacting significant individual test***





- (B) did not have a tax loss for the relevant year; or
  - (ii) the trustee did not make a distribution of income or capital at any time before the end of the CGT event year.<sup>16</sup>
- 5.15 In determining an entity's (the **holding entity**) indirect small business participation percentage in another entity (the **test entity**), section 152-75 ITAA 1997 requires the following to be multiplied:
- (a) the holding entity's direct small business percentage in an intermediate entity; and
  - (b) the sum of:
    - (i) the intermediate entity's direct small business percentage (if any) in the test entity at that time; and
    - (ii) the intermediate entity's indirect small business participation percentage in the test entity at that time (as worked out under the above).

Where there is more than one intermediate entity, the calculation is applied at each level.

- 5.16 Whether the CGT concession stakeholder test is met will either depend on:
- (a) an individual holds a 20% small business participation percentage interest in the object entity (or the spouse of that individual holds an interest in the object entity of greater than 0%); or
  - (b) an individual holding a 20% small business participation percentage interest or their spouse, and any other such persons holding a 90% interest in the taxpayer.

***Discretionary trust issues in meeting 20% small business participation percentage***

- 5.17 An overlooked issue may arise where there are discrepancies in the entitlements of the interest in the object entity.
- 5.18 For example, the small business participation percentage an entity has in a discretionary trust depends on:
- (a) if the trustee makes distributions of income during the income year (the relevant year) in which that time occurs--the percentage of the distributions to which the entity was beneficially entitled; or
  - (b) if the trustee makes distributions of capital during the relevant year--the percentage of the distributions to which the entity was beneficially entitled,

**or, if 2 different percentages are applicable, the smaller.**

- 5.19 Where the trustee of the discretionary trust makes a distribution of income **and** capital in an year and the percentages differ, the smaller percentage applies.
- 5.20 This may be problematic in circumstances where persons A and B are made presently entitled to income, whilst person C is made presently entitled to the capital in an income year (as a result of seeking to stream capital gains to a person holding capital losses).
- 5.21 In such circumstances, no person will be determined to hold a direct small business percentage in the discretionary trust as persons A, B and C will have both been entitled to either income or capital or the trust, but neither of the other (and the direct small business participation percentage considers the smaller percentage):

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<sup>16</sup> 152-70(6) ITAA 1997



<b>Beneficiary</b>	<b>Income %</b>	<b>Capital %</b>	<b>Direct small business participation percentage</b>
A	50%	0%	0%
B	50%	0%	0%
C	0%	100%	0%

- 5.22 Care must therefore be taken prior to the test point in time in ensuring appropriate trustee distribution minutes are prepared.
- 5.23 Further, where the terms of the trust deed cause a discrepancy in the definition of distributable income for the trust and capital, thought should be had as to the effect such distributions will be had to the relevant percentages.
- 5.24 ATO ID 2012/99 considers the meaning of the phrase 'distributions of income' and capital in the context of subsection 152-70(1) ITAA 1997 and states that '*references to distributions of income in the context of determining an entity's direct small business participation percentage in a trust mean the income of the trust, determined according to the general law of trusts, to which a beneficiary could be entitled. Depending on the deed and/or actions of the trustee, this may be an amount that differs from the ordinary income of the trust*'.
- 5.25 ATO ID 2012/99 notes that provided there is sufficient power in the trust deed, a trustee may validly resolve to treat capital gains as income of the trust and distribute such amounts accordingly.
- 5.26 Thought should also be had as to the effect TR 2012/D1 has in determining the income distributable by a trust and in turn the effect on determining an entity's small business participation percentage in the trust. Specifically, it should be noted that the **draft** ruling takes the view the income of the trust should not include notional amounts and therefore such notional amounts (such as franking credits and deemed capital gains) may not necessarily be income 'distributable' for the purposes of calculating the necessary percentages.
- 5.27 The interpretative decision acknowledges the decision in *Commissioner of Taxation v. Bamford* [2010] FCAFC 6; 2010 ATC 20-163 whereby the High Court determined that the term 'income of the trust estate' took its meaning according to appropriate accounting principles and the terms of the trust instrument.
- 5.28 ATO ID 2012/99 considered the following example:
- (a) Capital gain of \$90,000 made by a trustee of a discretionary trust in relation to the sale of shares in a company (the Object Entity).
  - (b) The trustee's interest in the company was 50%.
  - (c) In addition, the trustee derived ordinary income of \$10,000.
  - (d) The usual discretionary trust provisions applied as well as a power to determine whether receipts are on capital or revenue account.
  - (e) Pursuant to the relevant power, the trustee resolved to treat the \$90,000 capital gain as income of the trust and to distribute it to beneficiary A.
  - (f) Beneficiary B was distributed the \$10,000 ordinary income.



- (g) In determining the small business participation percentage held by beneficiary A and B in the Object Entity, it was noted that:
- (i) Beneficiary A held a 90% direct small business participation percentage in the discretionary trust (\$90,000/\$100,000 total income noting no capital distribution).
  - (ii) Beneficiary B held a 10% direct small business participation percentage in the discretionary trust (\$10,000/\$100,000 total income noting no capital distribution).
  - (iii) The discretionary trust held a 50% direct small business participation percentage in the Object Entity.
  - (iv) Beneficiary A therefore held a 45% indirect small business participation percentage in the Object Entity (90% \* 50%).
  - (v) Beneficiary B therefore held a 5% indirect small business participation percentage in the Object Entity (10% \* 50%).
  - (vi) Beneficiary A is therefore a CGT concession stakeholder in the Company as beneficiary A held a 45% small business participation percentage in the Company.
  - (vii) Further, an individual holding a 20% small business participation percentage interest in the Object Entity has a small business participation percentage in the discretionary trust of 90%.
  - (viii) It should be noted that if beneficiary B is a spouse of beneficiary A, they may also be considered a CGT concession stakeholder as they are a spouse of a significant individual (a person holding at least a 20% small business participation percentage interest in the Object Entity).
  - (ix) The interpretative decision further notes that the above *'result would be different if the trustee had not resolved to treat the capital gain as income of the trust and had instead distributed the capital gain to beneficiary A as a capital distribution. The additional basic condition under paragraph 152-10(2)(b) would not be met because beneficiary A and B would each have a direct small business percentage in the trust worked out under item 3 of the table in subsection 152-70(1) of 0% (being the smaller percentage of the distributions of capital and income to which each beneficiary is beneficially entitled).'*

5.29 Where a trustee fails to make a distribution of income or capital, care must be taken as an entity will be considered to hold a direct small business participation percentage of 0% in the trust if the trust had net income in that income year and did not have a tax loss. Thought should be had as to whether any 'default income' provisions exist as the wording of such provisions may result in the trustee being deemed to have exercised a power to distribute such income to beneficiaries of the trust.

5.30 In light of the above, where discretionary trust are involved in the chain of entities in determining whether there is a CGT concession stakeholder, steps should be taken in advance to ensure the circumstances and appropriate distributions are made. Often revisiting a trustee's distribution minute after an income year in which a CGT event occurred, will be too late to determine and ensure appropriate considerations are made.



## 6 Evidentiary requirements

### The continued need to read the deed

- 6.1 The need to review the trust deed does not stop following the identification of what is Distributable Income and who are the beneficiaries.
- 6.2 In fact, some deeds will mandate the need for certain processes to be followed.
- 6.3 The author has sighted 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.
- 6.7 Without a comprehensive review of the terms of the trust deed, such provisions would not be identified.
- 6.8 Separately, although it is generally known that trust distributions must be made by 30 June at the latest, a review of the deed is still required as 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.
- 6.9 Whether a trust distribution was made within the relevant period will ultimately come down to what can be proven.
- 6.10 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.
- 6.11 *The Trustee for Goldenville Family Trust A/C Xiangming Huang and Commissioner of Taxation (Taxation) [2025] ARTA 1355 (Huang Decision)* is a recent example where the Tribunal held (after having considered the evidence on hand) that minutes purported to have been signed prior to 30 June were in fact prepared in May the following year.

### Retention of documentation supporting timing and process

- 6.12 Factors in the Huang Decision that ultimately led the Tribunal in determining that trust minutes were not signed on or before 30 June in the relevant financial year included:
- (a) No documented or contemporaneous evidence being produced.
  - (b) The appointed director of the trustee company having no day-to-day understanding of the activities of the company; with such control being exercised by the husband of the director.



- (c) Multiple versions of a 30 June resolution with different signatures and no explanation.
  - (d) A 30 June resolution containing an 'estimated' distribution amount that was identical with the final tax return figure.
  - (e) Metadata showing that the resolution was not created until May the following year.
- 6.13 Accordingly, steps should be taken to ensure appropriate processes are in place that ensures any distribution consideration and discussions are undertaken and finalised prior to any distribution date (whether 30 June or such other date named in the trust deed).
- 6.14 Such steps may include:
- (a) Ensuring appropriate tax planning strategies are undertaken with sufficient time to prepare appropriate minutes.
  - (b) Appropriate file notes and correspondence retained on file to evidence discussions and determinations made prior to 30 June.
  - (c) Trust minutes sent to clients for execution with sufficient time for execution in compliance with corporations law and the company constitution. Where time is limited, provided electronic signing is authorised pursuant to the company constitution, then consideration should be had as to electronic signing.
  - (d) Arranging for any fully executed minutes to be uploaded and retained on file at the earliest convenience (as opposed to 11 months after the purported execution).
- 6.15 Where more detailed considerations are required in relation to distributions, particularly where section 100A may apply, additional steps should be taken:
- (a) In most cases:
    - (i) Ensuring each beneficiary recipient is advised of their entitlements in writing.
    - (ii) Ensuring the accounts of the trust properly reflect the treatment of such entitlement.
    - (iii) 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.
      - (A) In considering this step, thought should be had to ATO commentary at the time.
      - (B) 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.
      - (C) Where there are dealings amongst related family members, thought should be had whether such dealings may also be considered arm's length.
  - (b) Specifically where a distribution is made to a company beneficiary, then:
  - (c) The entering into a complying Division 7A loan agreement.
  - (d) 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).



- (e) Ensuring appropriate accounting records are retained.
  - (f) Evidencing any future dividend declared are sourced separate from the trust distribution.
- 6.16 In addition to the above practical steps, it is important that where a company acts as trustee, trust distributions also comply with general Corporations Law.
- 6.17 Specifically, where a trust distribution is to be made by way of minutes of meetings; then such minutes must be recorded within one month from the meeting and signed by the meeting's chair within a reasonable time.<sup>17</sup> In such circumstances, such notice provisions (or any applicable waivers) in the company constitution will be required to be met.
- 6.18 Alternatively, steps may be taken to pass a director resolution that requires the signing by each director of the trustee company.
- 6.19 As noted in the Huang Decision, the mechanisms in which a company has made its decision can be investigated and disputed in the event of an audit; and accordingly best-practice processes should be considered for all clients.
- 6.20 This is particularly important where a trust deed states that it allows oral trustee decisions to be made. Notwithstanding the trust deed allowing such decisions to be made; the mechanisms under general Corporations Law is still required to be met (i.e. appropriate notice provided in the event of calling a director meeting).

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<sup>17</sup> Section 251A *Corporations Act 2001*.



## 7 Consequences of invalid trust distributions

7.1 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.

7.2 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.

7.3 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.

7.4 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.

7.5 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).

7.6 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.

7.7 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).



7.8 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.”*

7.9 This option is not recommended in the context of the ATO's concerns outlined at issue 1 of TD 2012/22EC.

7.10 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.

7.11 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).



## 8 General trust distribution checklist

This checklist is not intended to be considered an exhaustive list but has been prepared to outline the various issues to consider prior to the preparation of a trust distribution resolution.

<i>Issue</i>	<i>What can go wrong?</i>
<b><i>The Who, What and When of Trust Distributions</i></b>	
Has the deed and all amending documents been validly executed/entered into?	Any identified defects should be rectified as soon as possible on the basis that difficulty may arise to rectify defects following identification by a Government body.
<p>Are the intended recipients beneficiaries of the trust?</p> <p>Are there any persons/groups of persons who are excluded as a beneficiary under the terms of the deed?</p>	<p>Confirm intended recipients are eligible to receive distributions from the trust.</p> <p>Common groups of persons who may be excluded as a beneficiary include, the Settlor and foreign persons.</p> <p>Less common groups of persons who may be excluded as a beneficiary include the trustee or former trustee; trusts or companies that the trustee or former trustee benefits from; persons on Centrelink benefits; the concept of a notional settlor.</p>
What 'income' can be distributed from the trust (E.g. what is distributable income)?	Confirm if income is according to ordinary principles, linked to section 95 income or if the trustee is able to determine the meaning of income.
Is there sufficient power to determine what distributable income is or categorise trust receipts/expenses on revenue or capital account?	If the defined meaning of Distributable Income in the trust is not preferred, identifying appropriate charactering powers is crucial in redefining the meaning of Distributable Income (within reasonable scope).
<p>Is there discretion to categorise and account income received as separate classes of income, specifically capital gains or franked distributions?</p> <p>Further, is there discretion to categorise and account expenses against separate classes of income and group classes of income?</p> <p>In addition, is there discretion to enable separate classes of income to be and distributed to different beneficiaries in such proportion as the trustee decides?</p>	<p>A broad review of the trust deed to ensure there are sufficient streaming provisions should be undertaken.</p> <p>Where no streaming provisions are present and the trust is in receipt of dividends and capital gains in addition to other sources of income; then steps may be taken to update the deed prior to any distribution being made (provided appropriate powers are exercised within any timeframes).</p>



Is there a power to accumulate income?	Absent this power, income would have to be distributed to beneficiaries.
Are there limitations on how the trustee may distribute income?	Some trust deeds may impose a 39% cap on distributions to certain classes of beneficiaries or may limit distributions to foreign persons.
Is consent or notice required when making income distributions?	Some trust deeds may require written 'Appointor' or 'Guardian' consent . We have identified deeds requiring such consent up to 14 days prior to distribution.
When must income distributions be made by?	Some trust deeds may require a distribution before 30 June.
Can distributions be orally recorded?	It is best practice, regardless of whether the deed allows it, to subsequently document oral distributions in writing and some trust deeds require oral declarations to be formalised by way of statutory declaration.
Is there a power to carry forward losses (e.g. the trustee is not required to utilise losses if not suitable)?	See paragraph 2.29 above.
Is there a power to offset income with previous year losses?	Consider whether the trust loss rules are met.
How are unpaid present entitlements treated?	Some trust deeds include provisions that cause an unpaid present entitlement to be converted into a loan.
Can the trustee make capital distributions prior to vesting?	Older trust deeds may not necessarily include a power to make distributions of capital prior to the vesting of the trust.  This is particularly of concern where Distributable Income is defined in a manner that does not include capital gains.
Are there restrictions on making capital distributions?	Some trust deeds may include restrictions on how capital distributions made by made.
What happens to any income not distributed or accumulated under a trustee's discretion?	If a valid trust distribution resolution is not prepared, it should be known who receives such income by default (or if the income is accumulated at the top marginal tax rate).
How is the income to be distributed (by way of specific amount or percentage)?	It is not recommended to distribute income with reference to the recipient's taxable



	<p>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.</p> <p>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.</p>
<b><i>The Why of Trust Distributions</i></b>	
Is there a distribution to a company?	Consider the operation of Division 7A.
Is there a distribution to an adult child or related family member not commonly involved within the family group?	Consider the operation of section 100A.
If a business is operated from the trust or from a company which the trust is a shareholder, will the distribution impact on who is considered 'connected with' the trust?	Consider if the recipient will cause difficulty in meeting any future MNAV Test or Turnover Test.
If a business is operated from a unit trust or company which the trust is a shareholder, will the distribution impact on who is a significant individual?	Consider any 'split' distributions of income and capital may affect there being a significant individual.
If losses are made in the trust, will the distribution impact on the ability to make a family trust election?	Consider if making distributions to persons outside the definition of 'family group' will impact the availability to access losses in the future.
If a family trust election has been made, will the distribution be within the family group?	Consider if Family Trust Distribution Tax will apply.
<b><i>The How of Trust Distributions</i></b>	
Has the trustee exercised 'real and genuine' consideration at the time of making the trust distribution	Failure to do so may enable challenges against a trust distribution by a disgruntled beneficiary.



## 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.

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