Trustee Distribution Resolutions: Where Do We Stand Now?

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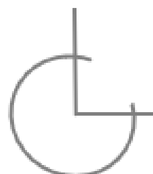

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1 Overview

1.1 The landscape of trust distributions in Australia has become increasingly complex due to a series of legal decisions and evolving guidelines from the Australian Taxation Office (**ATO**).

1.2 This paper will delve into these and other issues that may arise making trust distributions, including:

(a) Why a review of the trust deed is so important

(b) How various tax laws affect the trustee distribution resolution, including:

(i) section 100A ITAA 1936

(ii) the family trust election rules

(iii) the pattern of distributions test

(iv) the small business CGT concessions

(c) Preparing a distribution resolution where a trust:

(i) as prior year losses

(ii) operates as a professional firm (PCG 2021/4)

(d) Preparing a distribution resolution involving streaming of:

(i) capital gains and the impact of the 50% CGT discount and small business CGT concessions

(ii) franked dividends

(e) Can a trustee distribution resolution, based solely on the intention of saving tax, be at risk? (*Minerva Financial Group Pty Ltd*)

(f) What are the tax consequences if the ATO deem a trustee distribution resolution to be invalid?

(g) Checklist of tax considerations to take into account when preparing a trustee distribution resolution

1.3 Although this paper will include a general trust distribution checklist addressing trust income and capital distribution considerations, the author notes that each trust distribution resolution requires a careful review of the relevant trust deed as well as consideration of the circumstances surrounding the beneficiaries of the trust to ensure such distribution is valid. Accordingly, appropriate specialist advice should be sought as required.

1.4 Examples of the effect of certain trust resolutions in relation to the above issues are included throughout this paper under relevant sections.

1.5 A reference to ITAA 1936 in this paper is a reference to *Income Tax Assessment Act 1936* (Cth).

1.6 A reference to ITAA 1997 in this paper is a reference to *Income Tax Assessment Act 1997* (Cth).

2 Why a review of the trust deed is so important

2.1 A review of the trust deed **prior** to the making of any trust distribution resolution is crucial in ensuring that a valid distribution resolution can be prepared.

2.2 Importantly, the review of the trust deed allows for the following key questions to be answered:

(a) **What** are we distributing?

(b) **Who** are we distributing to?

(c) **When** must we make the distribution?

(d) **How** can we make a distribution?

2.3 Later sections of this paper will answer '**what** are we distributing' as well as '**why** are we making the distribution'.

2.4 This section will provide a broad overview of the remaining three questions.

Who are we distributing to

2.5 Perhaps the most important reason to review the trust deed is to know who is a beneficiary of the trust.

2.6 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.

2.7 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.

2.8 That said, the general class of beneficiaries cannot be assumed as every discretionary trust provider may adopt a different approach.

2.9 Some may restrict the general beneficiary class to: '*spouses, lineal descendants, parents, grand-parents and siblings*'.

2.10 Others may expand on the above general beneficiary class to include cousins and step-children.

2.11 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.

2.12 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.

2.13 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

2.14 Every discretionary trust deed should include a provision excluding certain persons from benefiting.

2.15 Whilst most (if not all discretionary trusts) should specifically exclude the settlor and entities associated with the settlor,[1] some other excluded persons may include

(a) a person considered a 'notional settlor' – considered below; and

(b) the trustee.

2.16 Further classes of persons may also be excluded, and the below provides brief considerations of provisions to be wary of.

Exclusion of notional settlor

2.17 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.'

2.18 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.

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[1] 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.

2.19 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.

2.20 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.

2.21 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

2.22 It can be common to find provisions excluding a trustee from benefiting from a trust, regardless of age.

2.23 The modern reason for the inclusion of such provisions relates to section 54(3) of the *Duties Act 1997* (NSW) which provides a nominal duty exemption for a change of trustee to a trust where:

(a) none of the continuing trustees remaining after the appointment of a new trustee are or can become a beneficiary under the trust;

(b) none of the trustees of the trust after the appointment of a new trustee are or can become a beneficiary under the trust; and

(c) the transfer is not part of a scheme for conferring an interest, in relation to the trust property, on a new trustee or any other person, whether as a beneficiary or otherwise, to the detriment of the beneficial interest or potential beneficial interest of any person.

2.24 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.

2.25 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.

2.26 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

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

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

2.29 Generally, if FATA is applicable to an investor, they are required to seek government approval of the investment. This screening and approval process are undertaken by the Foreign Investment Review Board (or more commonly referred to as FIRB).

2.30 While this paper is not intended to focus on FIRB and FATA, it is worthwhile understanding how FATA defines a foreign trust, as the approach adopted under this legislation can be found in other State tax legislations across the country (such as New South Wales subject to a minor modification).

2.31 Further (and as mentioned above), foreigners who acquire certain assets exceeding regulated thresholds, are required to apply for approval prior to acquisition. This process will cost time, but also an application fee will be payable.

2.32 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*'.

2.33 Substantial interest is defined to mean at least a 20% interest in an entity, while aggregate substantial interest is defined to mean at least a 40% interest in an entity.

2.34 Therefore, if a trust has:

(a) a 'foreigner' with a 20% interest in the trust; or

(b) multiple 'foreigners' with a 40% interest in the trust,

the trust will be a foreign person and potentially required to obtain approval for any investments into Australia.

2.35 While exact percentages can be identifiable when trusts have fixed interests, discretionary trusts provide the trustee with the flexibility in deciding the income and capital distributions on an annual basis.

2.36 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.[2] In other words, if there is no restriction on how much income or capital can be distributed to a beneficiary, then each beneficiary is deemed to hold a 100% beneficial interest in the trust.

2.37 Therefore, to ensure foreign persons cannot be deemed to hold a 100% beneficial interest in a discretionary trust, blanket bans on distributions to foreign persons are commonly included.

Distributions from trust to trust

2.38 All Australian jurisdictions except for South Australia have a statutory perpetuity period of 80 years. Some jurisdictions (namely Victoria, Tasmania, Western Australia and the Northern Territory) allows the common law perpetuity period to adopt 'a life in being plus 21 years' approach. Queensland may be adopted a longer perpetuity period in due course.

2.39 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.

2.40 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)[3] can be relied on in a situation where a trust distributes to another trust with a later perpetuity date.

2.41 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.

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

[3] Other States have similar provisions in their respective legislation.

2.42 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.

2.43 The case of *Domazet v Jure Investments Pty Limited* [2016] ACTSC 33 considered such a provision where the term 'General Beneficiaries' included the following:

> '*The trustee (in his capacity as such trustee) of any trust or settlement in which any Beneficiary has an interest whether absolute or contingent or by way of expectancy and whether liable to be defeated by the exercise of any power of appointment or revocation or to be diminished by the increase of the class to which that Beneficiary belongs which the Trustee may at any time and from time to time nominate in writing as a General Beneficiary and whether or not such trust or settlement is in existence at the date of this Deed* ***but provided that the beneficial interest in property provided by such trust or settlement shall vest within the perpetuity period applicable to the trusts*** *of this Deed'* (emphasis added)

2.44 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

2.45 Other potential exclusion provisions that may be found in a trust deed includes:

(a) Restricting the beneficiary class to a test individual and their family following a family trust election. Such restriction may be embedded to ensure no family trust distribution tax is payable as it would not be a valid distribution to distribute outside a family group.

(b) Excluding persons (and their associates) on social securities from benefiting from the trust. The need for such provisions arises as assets and income of a trust may form 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.

When must we make the distribution

2.46 Trust distributions must be made by 30 June at the latest.

2.47 Where there are ineffectual appointments as at 30 June, such amounts are to be distributed to the default beneficiaries of the trust.[4]

2.48 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.

2.49 Whether a trust distribution was made within the relevant period will ultimately come down to what can be proven.

2.50 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.

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[4] *Commissioner of Taxation v Ramsden* [2005] FCAFC 39 at [68] referencing *Commissioner of Taxation v Marbray Nominees Pty Ltd* (1985) 81 FLR 280 and *East Fnchlet v Federal Commissioner of Taxation i(1989) 90 ALR 456*

How can we make a distribution

2.51 The author has sighted trust deeds that may require another person to consent to any distribution of income or capital of the trust.

2.52 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."

2.53 Some alternatives may require at least 14 days written notice; whilst other may require the consent to be verified.

2.54 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.

2.55 Without a comprehensive review of the terms of the trust deed, such provisions would not be identified.

3 How various tax laws affect the trustee distribution resolution

3.1 Before drafting a family trust election, thought should be had as to why a distribution is being made and whether it may impact the application of various tax laws.

3.2 A lack of consideration may cause adverse implications for potential future distributions.

3.3 This section will consider four common tax provisions that are impacted by trust distributions:

(a) section 100A ITAA 1936.

(b) family trust election rules;

(c) the pattern of distributions test; and

(d) the small business CGT concessions.

Section 100A

3.4 Taxation Ruling TR 2022/4 (**TR 2022/4**)**,** Practical Compliance Guideline 2022/2 (**PCG 2022/2**) and Taxpayer Alert TA 2022/1 (**TA 2022/1**) outlines the ATO's position in interpreting section 100A ITAA 1936.

3.5 Broadly, section 100A is an anti-avoidance provision designed to prevent tax avoidance through trust structures which applies when a beneficiary of a trust becomes presently entitled to trust income under a reimbursement agreement. A reimbursement agreement involves an arrangement where someone other than the beneficiary benefits from the trust income and the arrangement is made with the purpose of reducing tax **and** is not made in the course of an ordinary family or commercial dealing.

3.6 TR 2022/4 and PCG 2022/2 provides guidance on what the ATO will consider an ordinary family or commercial dealing.

3.7 A detailed analysis regarding section 100A, TR 2022/4 and PCG 2022/2 is outside the scope of this paper, however, consideration will be had regarding what records should be maintained to support tax effective distributions to adult children and bucket companies in light of such ATO guidance.

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

3.8 TR 2022/4 notes that whether there is an ordinary family or commercial dealing will depend on all the relevant circumstances which would require considering of the historical behaviour of parties and whether the dealing:[5]

(a) is artificial or contrived

(b) is overly complex

(c) contains steps that are not needed to achieve the family or commercial objectives, or

(d) contains steps that might be explained instead by objectives different to those said to be behind the ordinary family or commercial dealing.

3.9 The ruling notes that the "*test can involve an inquiry into what the objectives of the dealing are and whether the steps that comprise the dealing would achieve that objective. It can also be relevant to inquire whether the dealing or steps within the dealing might be explained*

[5] TR 2022/4 at paragraph 27.

instead by objectives different to those said to be behind the ordinary family or commercial dealing. Illustrations can be found in case law:

(a) *In Prestige Motors, in concluding that the 3 transactions did not arise out of ordinary family or commercial dealing, the Court referred to the absence of commercial motivation or commercial necessity or justification for the transactions, and observed of one arrangement that the 'only explanation for the entry into the agreement ... [was] the elimination or reduction of tax liabilities'.*

(b) *In Guardian FCA, the Court (Logan J) identified an agreement involving the incorporation of a company, the nomination of that company as an eligible beneficiary of a trust that conducted investment activities and the subsequent appointment of income from those investment activities to the company. In concluding that the exception applied, the Court made findings on the evidence and posited that the identified agreement achieved the benefits of 'risk minimisation ... the shielding of distributed income and accumulated wealth from any creditors of individuals who were also members of the class of eligible beneficiaries' and the 'familial advantage ... of not having to make a large distribution in an income year to an individual'.*

(c) *In BBlood FCA, in concluding the arrangement was not an agreement entered into in the course of ordinary family or commercial dealing, the Court observed that the arrangement was unusual, was more complex than was necessary to achieve any specific purpose that could be described as 'ordinary family or commercial dealing', and was neither explicable as being for family succession or for commercial purposes. Further, the Court considered the arrangements in the context of the historical behaviour of the parties, concluding that it was inconsistent with that behaviour and that no sensible commercial or family rationale had been established for adopting the buy-back procedure*."[6]

3.10 TR 2022/4 also acknowledges that cultural factors may inform the question on whether a dealing is an 'ordinary family dealing' distinguishing family dynamics where it is cultural for '*grandparents* [to gift]…*money or goods to younger members of the family*'[7] to those where a beneficiary '*for religious reasons will not accept the entitlement*'.[8] Consideration may also be held whether cultural practices of a family group extends to circumstances where it is expected that '*children will meet the needs for shelter and living of their parents and other older relatives when they are no longer participating in the workforce*'.[9]

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

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

(a) *"If the arrangements were to involve parents gifting money received from a trust to their children repeatedly and one or more of the following factors are present*

(i) *the parents have a lower marginal tax rate*

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[6] TR 2022/4 at paragraph 98
[7] TR 2022/4 at paragraph 110
[8] TR 2022/4 at paragraph 113.
[9] TR 2022/4 at paragraph 111.

(ii) *the parents have lesser financial means than the adult child, or*

(iii) *the adult child is also capable of benefitting under that trust in their own right; for example, the parents may be subject to lower tax rates because they are retired and in pension phase or have significant losses to reduce tax payable on trust distributions.*

(b) *Arrangements where the situation is reversed, so that Alex (who has limited financial resources apart from a distribution made to her and has a lower marginal tax rate) gifts money to her parents Lisa and Jessie who are subject to higher rates of tax, and there is no financial or cultural circumstance that would explain the gift.*

(c) *Arrangements where Alex, who has a lower marginal tax rate, agrees to apply her trust entitlements to reimburse her parents for costs incurred by them on her maintenance, education and financial support while Alex was a minor."*

3.13 Given the prevalence of trusts as a business and investment vehicle, it is acknowledged that undertaking the above analysis for each family group may not be possible.

3.14 Accordingly, PCG 2022/2 provides 'Green zone' scenarios in which the ATO will not dedicate compliance resources given the low risk nature of such examples.

3.15 It should be noted that PCG 2022/2 does not state the law, but rather outlines scenarios that are more likely to be criticised than others.

3.16 In relation to a company beneficiary, Scenario 3B of PCG 2022/2 notes that distributions to a company beneficiary may fall within the green zone where:

(a) there is a retention of funds;

(b) the company is not an exempt entity;

(c) the company is a member of the same family group (see paragraph 25(f) for the meaning of family group);

(d) the retained funds are used for the working capital of a business that the trust actively carries on; or are used to acquire, maintain or improve investment assets of the trust (as well as other circumstances – see paragraph 25(c) for additional circumstances and paragraph 25(d) for situations when this condition will not be met);

(e) a complying Division 7A loan agreement is entered into (note TD 2022/2 discussed above);

(f) none of the following exclusions apply:[10]

(i) *the arrangement is a red-zone arrangement (see paragraphs 34 to 48 of PCG 2022/2)*

(ii) *the beneficiary makes a gift of the funds received either in satisfaction of their trust entitlement or from an associated amount (an example of an associated amount includes where the unpaid present entitlement (UPE) was converted into a loan) except where the gift meets the requirement of Green zone: scenario 1*

(iii) *the beneficiary disclaims their entitlement or forgives or releases the trustee from its obligation to pay their trust entitlement or an associated amount*

[10] PCG 2022/2 at paragraph 32.

receivable from the trust (an example of an associated amount is where the UPE was converted into a loan)

(iv) *the beneficiary's entitlement is less than the beneficiary's share of net income, franked dividends of the trust and trust capital gains as a result of the trustee exercising a power, or the deed being amended or varied, to affect the quantum of income of the trust estate*

(v) *a beneficiary's trust entitlement is satisfied by payments that are sourced from that beneficiary, or a beneficiary's trust entitlement has been made subject to a loan agreement and the repayments of that loan are sourced from payments or loans from that beneficiary; examples include where a trustee*

(A) *satisfies a corporate beneficiary's UPE or makes a loan repayment to that corporate beneficiary by way of set-off against a dividend paid by that corporate beneficiary*

(B) *issues units in the trust to the beneficiary and the amount owed for the units is set-off against the amount payable by the trust to the beneficiary, or*

(C) *satisfies a beneficiary's entitlement or satisfies a loan repayment to that corporate beneficiary by way of set-off against that trustee's entitlement to income of another trust that includes franked distributions paid by that corporate beneficiary*

(vi) *the beneficiary is a loss company or loss trust that uses its trust entitlement to fund a distribution to its members and that distribution compromises the ability of the beneficiary to repay its existing or future liabilities*

(vii) *the beneficiary is a private company that uses its trust entitlement to fund a distribution that is made directly or indirectly to a non-resident*

(viii) *the beneficiary is a private company or trust that uses its trust entitlement to fund a distribution that is made directly or indirectly to the trustee that made the beneficiary presently entitled to income*

(ix) *the trustee has not notified the beneficiary of their entitlement to trust income by the earlier of the trustee's due date and actual date of lodgment*

(x) *where the beneficiary that is presently entitled to trust income in a year is required to lodge a tax return for that year, either the*

(A) *beneficiary has not lodged, or*

(B) *the beneficiary has understated or omitted in that tax return their share of the trust net income, trust capital gains or franked dividends received from the trust*

(xi) *the beneficiary uses the trust entitlement to pay excessive consideration where the parties are not dealing at arm's length.*

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

(a) The entering into a complying Division 7A loan agreement.

(b) Evidencing the use of such retained funds in the working capital for the trust (whether noting by way of resolution, notes or records of discussions or meetings).

(c) Ensuring appropriate accounting records are retained.

(d) Evidencing any future dividend declared are sourced separate from the trust distribution.

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

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

(i) distribution is paid to the parent or caregiver of the beneficiary in connection with expenses incurred before the beneficiary turned 18 years of age;

(ii) distribution is applied by the trustee of the trust against a debit balance account for the beneficiary representing expenses incurred by the trustee in respect of the beneficiary before they turned 18 years of age; or

(iii) adult beneficiary is a non-resident relative of the resident controller of the trust and the distribution is made available to a resident taxpayer by way of loan or gift.

(b) TA 2022/1 – which outlines the scenarios in which the ATO will consider parents as benefiting from trust distributions made to adult children. Such arrangements cause concern given the ability to access tax-free thresholds or lower marginal tax rates of such adult children.[11]

3.19 TA 2022/1 provides the following two examples of trust distributions to adult children failing to fall within the meaning of ordinary family dealing.

Example 1

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

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

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

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

[11] TA 2022/1 at paragraph 3.

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

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

Example 2

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

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

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

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

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

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

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

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

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

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

22. Although $30,000 of the $40,000 is not received directly by Genevieve, and might appear to be within the scope of this Alert, it is important that the $30,000 is applied to repay loans for legitimate expenses that might ordinarily be borne by an adult child and were temporarily met on Genevieve's behalf (being tuition fees and arm's length board). The remaining $10,000 was actually received by Genevieve. Accordingly, the concerns raised in this Alert do not arise in arrangements of this type."

3.21 An important distinction between Examples 2 and 3 of TA 2022/1 is whether the 'reimbursement' to the parent from the child (using the trust distribution funds) is in relation to expenses incurred by the parent whilst the child was a minor or over 18. Where the reimbursement relates to expenses incurred whilst the child was a minor, such reimbursements would fall within Red Zone scenario 1 of PCG 2022/2.

3.22 Other than considering the above ATO guidance, steps should be taken to ensure the proper administration of the trust.

3.23 This may include the following:

(a) Appropriate steps to ensure trust resolutions are prepared pursuant and in compliance with the terms of the trust deed.

(b) Ensuring each beneficiary recipient is advised of their entitlements in writing.

(c) Ensuring the accounts of the trust properly reflect the treatment of such entitlement.

(d) Where a beneficiary wishes to apply their entitlement in a certain manner (whether by way of gift or loan), steps should be taken that appropriate written documentation are drawn and executed to confirm how such entitlement is to be dealt with.

(i) In considering this step, thought should be had to ATO commentary at the time.

(ii) This may include ensuring proper evidence and records are retained as to any expenses incurred by an adult child but paid for by another family member.

(iii) Where there are dealings amongst related family members, thought should be had whether such dealings may also be considered arm's length.

3.24 Importantly, trustees of a trust should not be seen as influencing beneficiaries in making such decisions relating to their entitlement prior to any trust distribution. This may mean that beneficiaries are informed of their ability to seek payment of their entitlement in cash, if they so choose.

Family trust election rules

3.25 The need to make a family trust election may impact on trust distributions to be made. This is because once a family trust election is made, a Test Individual (discussed further below) and their **family group** may receive distributions from the trust without adverse tax implications

3.26 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.

3.27 Schedule 2F of ITAA 1936 contains the relevant legislation regarding the ability to utilise trust losses.

3.28 Due to the difficulty of a discretionary trust to utilise existing tax losses via a distribution from another discretionary trust, it is recommended a family trust election be made in favour of the trust.

3.29 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.

3.30 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).

3.31 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.

3.32 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

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

3.34 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.

3.35 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

3.36 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.

3.37 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.

3.38 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.

3.39 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.

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

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

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

3.43 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

3.44 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.

3.45 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.

3.46 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.

3.47 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.

3.48 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.

Pattern of distribution

3.49 Where a family trust election is not made regarding a discretionary (also known as a non-fixed for the purposes of the legislation) trust, in order for that discretionary trust to potentially utilise losses, the pattern of distributions test must be met.

3.50 The pattern of distribution test will be satisfied if, within 2 months of the end of the income year:

(a) the trust distributed directly or indirectly to the same individuals, for their own benefit, a greater than 50% share of all test year distributions of income; and

(b) the trust distributed directly or indirectly to the same individuals (who may be different from those in paragraph (a)), for their own benefit, a greater than 50% share of all test year distributions of capital.[12]

3.51 A 'test year distributions' of income or capital is the total of all distributions of income or capital made in any of the following periods (provided it did not being more than 6 years prior):[13]

(a) the period from the income year being considered until 2 months after its end;

(b) if the trust distributed income before the loss year – the income year, before the loss year, that is closest to the loss year;

(c) if paragraph (b) does not apply and the trust distributed income in the loss year – the trigger year;

(d) if neither paragraphs (b) or (c) applies – as the income year, closest to the trigger year, in which the trust distributed income;

(e) each intervening income year (if any) between the one in paragraph (a) and the one in paragraph (b), (c) or (d).

3.52 The effect of the test is to ensure that distributions of a trust that has incurred a loss remains with the same majority of individuals.

[12] Section 269-90 ITAA 1936
[13] Section 269-95 ITAA 1936

3.53 In this regard, the pattern of distribution test adopts the same broad definition of 'distributed' as outlined in paragraphs 3.44 and 3.46; so care is required regarding the broader administration and activities of the trust in satisfying this test.

Small business CGT concessions

3.54 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.

3.55 Specifically, where the business is operated from a trust (or shares in a company are held by a trust that may declare dividends from the company), improper distributions may result in the inability to access the small business CGT concessions in future years (or the current year).

Trust distributions affecting small business CGT concession eligibility

3.56 A key requirement to accessing the small business CGT concessions is that a taxpayer either is a small business entity for the income year (**Turnover Test**) or satisfies the maximum net asset value test (**MNAV Test**).

3.57 In order to meet either test, the following must be satisfied:

(a) Regarding the Turnover Test, one of the requirements to be met is that the entity's aggregated turnover for a year is less than $2 million. 'Aggregated turnover' means the sum of the relevant annual turnovers of the following (per section 328-115 ITAA 1997):

(i) the entity's (taxpayer's) annual turnover for the income year;

(ii) the annual turnover for the income year of any entity that is connected with the taxpayer at any time during the income year; and

(iii) the annual turnover for the income year of any entity that is an affiliate of the taxpayer at any time during the income year.

(b) Regarding the MNAV Test, the sum of the following must not exceed $6,000,000 (per section 152-15 ITAA 1997):

(i) the net value of the CGT assets of the entity (the taxpayer);

(ii) the net value of the CGT assets of any entities connected with the taxpayer; and

(iii) the net value of the CGT assets of any affiliates of the taxpayer or entities connected with the taxpayer's affiliates (not counting any assets already counted under paragraph (ii)).

3.58 A common link with both tests is this notion of an entity 'connected with' the taxpayer (in that the connected entity's turnover or net value of CGT assets are included in the test). The question, therefore, is how can a discretionary trust's distribution affect who is connected with a taxpayer.

Who can be connected with an entity

3.59 Under section 328-125 ITAA 1997, an entity is connected with another entity if:

(a) Either entity is controlled by the other; or

(b) Each entity shares a common controller.

3.60 For these purposes, the meaning of control is specifically set out in the legislation and includes different tests for determining control of different types of entities.

3.61 Control for discretionary trusts are stated under section 328-125(3) ITAA 1997 as follows:

(3) An entity (the first entity) controls a discretionary trust if a trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of the first entity, its affiliates, or the first entity together with its affiliates.

(4) An entity (the first entity) controls a discretionary trust for an income year if, for any of the 4 income years before that year:

(a) the trustee of the trust paid to, or applied for the benefit of:

(i) the first entity; or

(ii) any of the first entity's affiliates; or

(iii) the first entity and any of its affiliates;

any of the income or capital of the trust; and

(b) the percentage (the control percentage) of the income or capital paid or applied is at least 40% of the total amount of income or capital paid or applied by the trustee for that year.

3.62 Importantly, a trust's distribution history may impact who is included in the calculation of a Turnover Test or MNAV Test in the future.

3.63 For example, an inadvertent distribution to an adult child or related family member who holds substantial assets (that fall within the definition of net value of CGT assets) or operates a business with a high turnover, may result in such assets or turnover being included in accessing whether an entity satisfies the Turnover Test or MNAV Test.

3.64 Alternatively, distributions to entities controlled by family members may cause unnecessary grouping.

3.65 Steps should therefore be taken to have appropriate tax planning discussions with clients prior to trust distributions being drawn, particularly, when business plans anticipate a likely sale in the near future for an entity.

Trust distributions impacting significant individual test

3.66 Where the small business CGT concessions are being sought in relation to the sale of shares in an entity operating a business(**object entity**), section 152-10(2)(d) ITAA 1997 requires either of the following to be satisfied just before the CGT event:

(a) the taxpayer is a CGT concession stakeholder in the object entity; or

(b) CGT concession stakeholders in the object entity together have a small business participation percentage in 'you' (the taxpayer) of at least 90%.

3.67 Section 152-60 ITAA 1997 states that '[a]*n individual is a* ***CGT concession stakeholder*** *of a company or trust at a time if the individual is:*

(a) *a **significant individual** in the company or trust; or*

(b) *a spouse of a significant individual in the company or trust, if the spouse has a small business participation in the company or trust at that time that is greater than zero*.'

3.68 Section 152-55 ITAA 1997 states that '[a]*n individual is a **significant individual** in a company or a trust at a time if, at that time, the individual has a **small business participation percentages** in the company or trust of at least 20%'.*

3.69 Section 152-65 ITAA 1997 states that '[a]*n entity's small business participation percentage in another entity at a time is the percentage that is the sum of:*

(a) *the entity's **direct small business participation percentage** in the other entity at that time; **and***

(b) *the entity's **indirect small business participation percentage** in the other entity at that time.*

3.70 In determining an entity's direct small business participation percentage, section 152-70 ITAA 1997 notes in relation to a trust (<u>where entities do not have entitlements to all the income and capital of the trust – e.g. a discretionary trust</u>) – this percentage is:

(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.

3.71 Care should also be taken where the trustee of the trust fails to make a distribution of income **and** fails to make a distribution of capital:[14]

(a) if the trustee made a distribution of income or capital during the CGT event year, consider that year in determining the income or capital percentages; otherwise, consider the last income year before the CGT event year in which the trustee did make a distribution of income or capital;[15]

(b) despite the above adjustment, an entity holds a direct small business participation percentage of 0% in the trust at the relevant time if either:

(i) the trust:

(A) had a net income for the relevant year; and

(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.[16]

3.72 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

[14] 152-70(4) ITAA 1997
[15] 152-70(5) ITAA 1997
[16] 152-70(6) ITAA 1997

(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.

3.73 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

3.74 An overlooked issue may arise where there are discrepancies in the entitlements of the interest in the object entity.

3.75 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.

3.76 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.

3.77 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).

3.78 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):

Beneficiary	***Income %***	***Capital %***	***Direct small business participation percentage***
A	50%	0%	0%
B	50%	0%	0%
C	0%	100%	0%

3.79 Care must therefore be taken prior to the test point in time in ensuring appropriate trustee distribution minutes are prepared.

3.80 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.

3.81 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*'.

3.82 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.

3.83 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.

3.84 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.

3.85 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).*'

3.86 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.

3.87 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.

4 Preparing a distribution resolution with losses and personal services income

Trust losses

4.1 Prior sections of this paper considered the requirements under various tax provisions to utilize trust losses.

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

4.3 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.

4.4 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.

4.5 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) The definition of income of the trust deed is 'income according to ordinary accounting principles'.

(d) There is no provision in the trust deed that enables the trustee with the power not to offset prior year trust losses.

(e) As carry forward losses exceed the income derived from income (according to ordinary concepts), there is no distributable income of the trust.

(f) There would be net taxable income of $20,000, however, and as no beneficiary can be made as presently entitled (due to there being no distributable income), the franking credits would not be refundable.

4.6 The section of this paper titled 'Preparing a distribution resolution involving streaming' considers the distinction between distributable income and net taxable income in further detail.

Personal services income

4.7 The personal services income provisions (**PSI provisions**)[17] operate to:

(a) deny various deductions against personal services income;[18] and

(b) attribute any 'personal services income' (that is income derived as a reward for one's personal efforts or skills)[19] from an entity to the individual performing the work.[20]

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[17] Divisions 84 to 86 ITAA 1997
[18] Division 85 ITAA 1997
[19] Section 84-5 ITAA 1997
[20] Division 86 ITAA 1997

4.8 Where a trust generates personal services income, then consideration of the PSI provisions may impact how trust distributions may be made. That is, unless an exception applies, personal services income generated by a trust must be attributed to the individual performing the work.

4.9 An exception applies to the above where the trust (termed as the personal service entity) is conducting a personal services business.[21]

4.10 In order to be considered a 'personal services business', the personal service entity only needs to meet one of four following tests.

4.11 The relevant tests include:

(a) the results test – where it can be shown that the income was for the production of a result among other requirements;

(b) the unrelated client test – where it can be shown that the income was derived from unrelated clients and as a product of the personal service entity making offers or invitations to the public at large;

(c) the employment test – where it can be shown that a portion of the income generated by a business structure is through the use of persons 'employed' or engaged with a business structure (not related to the key business owner/associated persons); or

(d) the business premises test – where it can be shown that a business structure runs the business through a separate business premises.

4.12 It is not required to meet more than one of above four tests to be considered a personal services business.

4.13 While only one of the tests needs be satisfied, it may be preferable in the long term for the personal service entity to meet more tests (i.e. to reduce the likelihood of a future restructuring of the business falling within the general 'anti-avoidance' arguments).

4.14 The PSI provisions are tested on an income year by income year basis. As such, so long one of the tests are satisfied in an income year (it can be a different test each year), the sole trader will be considered a personal services business.

4.15 If none of the tests are able to be satisfied, then steps can be taken to obtain a personal services business determination from the ATO.

4.16 TR 2022/3 provides a comprehensive summary of the ATO's position in relation to the application of the PSI provisions and is recommended reading for a summarised position.

4.17 It is outside the scope of this paper to consider the PSI provisions in detail.

4.18 Rather, this paper considers how the deriving of personal services income may impact how trust distributions are to be made.

4.19 If the Company is considered a personal services business, then the personal services income provisions will not apply.

4.20 Although there are provisions ensuring PSI generated in a business structure is not assessable to an individual, every personal services business should consider the potential for the ATO Commissioner to seek to apply the general anti-avoidance provisions of Part IVA ITAA 1936.

[21] Section 85-30 ITAA 1997

4.21 Factors for personal services business that can suggest Part IVA not applying can include the following (but are not limited to):

(a) if a business structure engages staff to generate fees (much like satisfying the employment test discussed above);

(b) if a business structure is a 'trading' business as opposed to a 'service' business, that is a business structure makes money from the sale of goods rather than ones' personal labour;

(c) if the business was started in a business structure at inception rather than restructuring from an individual into a discretionary trust, as there would be no tax benefit;

(d) if key individuals receive an appropriate level of remuneration for their services to a business structure, the benchmark for such remuneration is the remuneration paid to the comparable persons in the relevant industry;

(e) an appropriate portion of a business structure's business income is assessable in key individual's hands.

4.22 The above factors need to be considered on a case by case basis, and on a year by year basis.

4.23 Further, Practical Compliance Guidelines 2021/4 outlines the ATO's position on how they will apply the anti-avoidance provisions for professional practices.

4.24 In determining whether the guidelines apply, two 'gateways' are required to be satisfied:

(a) First, there must be a sound commercial rationale for entering into the trust (or company) structure. Indicators that lack a sound commercial rationale include the following:

(i) The arrangement seems more complex than is necessary to achieve the relevant commercial objective.

(ii) The arrangement includes a step, or a series of steps, that appears to serve no real purpose other than to gain a tax advantage; for example

(A) transactions which interpose an entity to access a tax benefit;

(B) intra-group or related-party dealings that merely produce a tax result, or

(C) arrangements involving a circularity of funds or no real money.

(iii) The tax result of the arrangement appears at odds with its commercial or economic result; for example, a tax loss is claimed for what was a profitable commercial venture or transaction.

(iv) The arrangement results in little or no risk in circumstances where significant risks would normally be expected; for example

(A) use of non-recourse or limited recourse loans which limit the parties' risk or actual detriment in relation to debts/investments

(B) arrangements where the taxpayer's risk is significantly limited because of the existence; for example, of a 'put' option.

(v) The parties to the arrangement are operating on non-commercial terms or in a non-arm's length manner; for example

(A) financial arrangements made on unusual terms, such as interest rates above or below market rates, insufficient security or deferment of repayment of the loan until the end of a lengthy repayment period;

(B) transactions which do not occur at market rates/value.

(vi) There is a gap between the substance of what is being achieved under the arrangement (or any part of it) and the legal form it takes; for example, arrangements where a series of transactions taken together produce no economic gain or loss, such as where the whole scheme is self-cancelling.

(b) Secondly, there must not be any 'high-risk features' which can include the following:

(i) financing arrangements relating to non-arm's length transactions;

(ii) exploitation of the difference between accounting standards and tax law;

(iii) arrangements where a partner assigns a portion of a partnership interest that is materially different in principle from certain cases;

(iv) multiple classes of shares and units held by non-equity holders.

4.25 Where the above 'gateways' are met, then PCG 2021/4 can be relied upon in determining the level of risk related to the trust in making trust distribution resolutions.

4.26 PCG 2021/4 "*adopts a risk assessment methodology made up of three risk zones (low, moderate and high) to assess your profit allocation arrangement. The risk zone applicable to your arrangement is determined by combining your scores for each of the three risk assessment factors in paragraph 76 of this Guideline. In most cases, it is only necessary to consider the first two risk assessment factors, but in some cases it may be appropriate to consider all three*." (paragraph 66).

4.27 The methodology is summarised in the following table (per paragraph 76):

Risk assessment factor	Score					
	1	2	3	4	5	6
(1) Proportion of profit entitlement from the whole of firm group returned in the hands of the IPP	>90%	>75% to ≤90%	>60% to ≤75%	≥50% to ≤60%	>25% to <50%	≤25%
(2) Total effective tax rate for income received from the firm by the IPP and associated entities [6]	>40%	>35% to ≤40%	≥30% to ≤35%	>25% to <30%	>20% to ≤25%	≤20%
(3) Remuneration returned in the hands of the IPP as a percentage of the commercial benchmark for the services provided to the firm	>200%	>150% to ≤200%	>100% to ≤150%	>90% to ≤100%	>70% to ≤90%	≤70%

4.28 In determining how profit is dealt with, consideration should be had as to the relevant score for each risk assessment factor and we note that (per paragraph 78):

Risk zone	Risk level	Aggregate score against first two factors	Aggregate of all three factors*
Green	Low risk	≤7	≤10
Amber	Moderate risk	8	11 & 12
Red	High risk	≥9	≥13

(a) Where an amber or red zone applies, the ATO may/will (respectively) conduct further analysis of the trust's circumstances.

(b) Where a green zone applies, the ATO will only apply compliance resources to review the trust's allocation of profit in exceptional circumstances (namely where they do not believe the self-assessment is correct).

4.29 As mentioned above, the analysis should be conducted annually.

5 Preparing a distribution resolution involving streaming

5.1 Before determining how income should be streamed, 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)

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

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

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

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

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

(a) Such share of the 'income of the trust' to which a beneficiary is entitled to receive is calculated (which we will call **Distributable Income** but can also be known as **Trust Income** and is commonly referred to as 'accounting incoming' in trust deeds).

(b) The beneficiary is taxed on such share of the 'net income of the trust estate' that is attributable to such a beneficiary (which we will define as **Net Tax Income** but is also known as 'section 95' income).

5.4 As to the meaning of 'income of the trust' estate and 'net income of the trust estate', the High Court case of *Bamford*[22] 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.

5.5 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.

[22] *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

5.6 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.[23]

5.7 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.

5.8 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.

[23] 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

5.9 The outcome of *Bamford* did force a change in law regarding the taxation of trusts.

5.10 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.

5.11 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.

5.12 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.

5.13 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.[24]

(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';

[24] 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.

5.14 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.

5.15 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.

5.16 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.

5.17 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.

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

The importance in understanding what is Distributable Income

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

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

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

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

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

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

(a) Distributable Income means income according to ordinary concepts.

(b) Distributable Income means section 95 income (or Net Tax Income) less notional amounts.

(c) Distributable Income means such amount which the trustee determines.

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

5.26 Where Distributable Income is defined to mean section 95 income, then only part of a capital gain would be included where the 50% CGT discount applies. Part of the capital gain would still be sheltered and if streaming is required, a separate distribution of capital would be required in tandem with an appropriately drafted classification of the taxable capital gain as a separate income class.

5.27 Where Distributable Income means such amount which the trustee determines, then flexibility is offered to trustees to determine the manner in which they wish to define Distributable Income, provided it is within reason.[25]

[25] 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.

5.28 Given the benefits in being able to determine income in a wide range of manners, trust deeds should ideally (but not always) contain additional powers for the trustee to: be able to recharaterise receipts and outgoings as income or capital, account for and deal with separate classes of income and determine whether or not to offset prior year trust losses against current year income.

6 Can a trustee distribution resolution be based solely on the intention of saving tax

6.1 The decision in *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2022] FCA 1092 (**Minerva**) brought cause to concern when the Commissioner successfully argued that Part IVA applied to certain schemes which included a trustee's distribution decision.

6.2 Minerva has since been overturned at appeal *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 (**Minerva Appeal**), however, such outcome has not changed the Commissioner's position in relation to their long-held view that schemes which include a trustee's exercise of discretion to distribute income can attract the operation of Part IVA as they have outlined in their Decision Impact Statement of the Minerva Appeal.

Minerva

6.3 Minerva involved three 'Schemes', two of which were initially determined to potentially fall foul of Part IVA.

6.4 Relevant to the facts of Minerva was a restructure that resulted in two Siloed Groups of entities owned by an international holding entity:

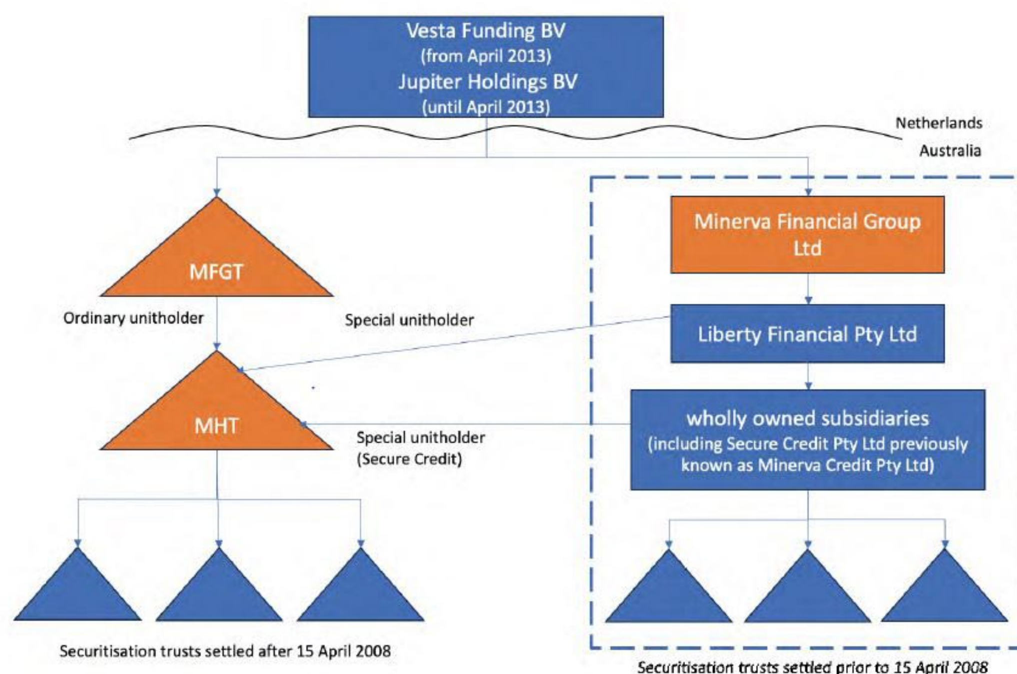
(a) The Corporate Silo comprised of Minerva Financial Group Ltd as well as:

(i) Liberty Financial Pty Ltd (as subsidiary); and

(ii) Various other wholly owned subsidiaries to Liberty Financial Pty Ltd; and

(b) The Trust Silo which comprised of various securitized trusts under a holding trust (Minerva Holding Trust (**MHT**)), of which another trust (**MFGT**) was the sole ordinary unitholder in MHT.

6.5 A diagrammatic summary of the structure is as follows:



6.6 The Second and Third Schemes effectively involved:

(a) the trustee of MHT choosing not to exercise its discretion to make any substantive distribution to the special unitholders (Liberty Financial and the wholly owned subsidiaries); and

(b) the trustee of MHT lending monies to Liberty Financial (with interest applying).

6.7 The resulting effect is that distributions from the Trust Silo (which included the interest received from the loan to Liberty Financial) would be subject to 10% withholding tax, whilst distributions from the Corporate Silo attracted a 30% tax rate.

6.8 At first instance, the Court noted:[26]

[564] The applicant was unable to provide any cogent reason, other than the tax benefit, why the decision was taken in each of the relevant years to direct no more than 2% of MHT's net income to the special unitholders. The applicant submitted that neither LF nor Secure Credit had an "entitlement" to the income from the RIUs and that the power of the trustee of MHT to distribute income to the special unitholders was discretionary. So much, unsurprisingly, was accepted by the Commissioner. But neither factor goes to the relevant question of dominant purpose, objectively viewed.

[565] In those circumstances, I agree with the Commissioner's submission that, viewed objectively, the exercise of the choice in each of the relevant years (the manner in which the second part of the second scheme was carried out) was driven by the tax benefit of directing income away from LF. Having found that this factor is neutral insofar as it relates to the first part of the second scheme, I agree with the Commissioner's submission that, objectively, the manner in which the second scheme was entered into is indicative of a dominant purpose of obtaining that tax benefit.

6.9 Accordingly, it held that Part IVA could apply, but more worrisome, Minerva provided some scope for a trustee's discretionary decision-making role to be scrutinised through Part IVA. In Minerva the trustee's decision scrutinised was the non exercising of a discretion to make a distribution to the special unitholders (being entities within the Corporate Silo).

Minerva Appeal

6.10 On 8 March 2024, the Full Federal Court allowed the taxpayer's appeal of the Minerva decision.

6.11 While a full analysis of Part IVA is outside the scope of this paper, the Court noted the following in rejecting the conclusion of the primary judge.

(a) Part IVA requires an objective assessment of the purpose behind entering into or executing the scheme, based on the statutory factors listed in section 177D of the Income Tax Assessment Act 1936.

(b) It does not allow for an investigation into the subjective motives of the taxpayer or other participants.

(c) The test for determining dominant purpose is not a "but for" test and does not involve causation.

(d) Simply choosing between two transaction forms based on tax considerations does not, in itself, indicate that the scheme was entered into with the dominant purpose of obtaining a tax benefit, considering the section 177D factors.

[26] *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2022] FCA 1092 at paragraphs [564] and [565]

(e) Part IVA does not mandate that a taxpayer must choose a transaction form that results in the highest or higher tax payable.

6.12 After restating these principles, the Full Court identified a "difficulty" in the primary judge's reasoning. The judge concluded that the taxpayer's inability to provide a convincing reason (other than the tax benefit) for its income distribution decisions suggested that the manner and timing of the schemes indicated the schemes were entered into for the dominant purpose of obtaining a tax benefit.

6.13 This approach conflated the objective determination of purpose with an inquiry into whether the trustee's discretion would have been exercised differently without the tax benefit. The Full Court reiterated that purpose must be determined objectively, and subjective commercial reasons or motives do not answer the question posed by Part IVA.

6.14 On appeal, the Commissioner argued that the Liberty Financial group's conduct before its restructure into the Corporate Silo and Trust Silo supported the conclusion that the schemes were entered into with the dominant purpose of obtaining a tax benefit. The Commissioner viewed the pre-reorganisation characteristics as a lens to understand the objective purpose of subsequent conduct. However, the Full Court found two fundamental flaws in this argument, being:

(a) The reorganisation into Corporate Silo and Trust Silo was not challenged as a scheme on appeal.

(b) The group's business had grown significantly and its funding sources had changed, making it inappropriate to use pre-restructure characteristics to draw conclusions about post-restructure conduct.

6.15 After recognizing that the Corporate Silo and Trust Silo were part of a legitimate restructure, the focus shifted to whether the specific method of making distributions within that structure triggered Part IVA.

6.16 The Full Court further determined that the trustee of the MHT simply distributed income according to the MHT's constitution and the terms of the issued units (which had their "expected features"), and these distributions provided real benefits to the unitholders.

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

[77] Absent anything further in the surrounding circumstances, the manner in which distributions were made does not objectively support a conclusion that a party entered into or carried out any of the schemes for the dominant purpose of enabling the appellant to obtain a tax benefit.[27]

[27] *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 at paragraphs [76] and [77]

6.17 In addressing the fact that the trustee discretion was exercised at the end of each financial year, the Full Court noted that they were exercised in accordance with "*terms of the MHT constitution and the need for the trustee to make a resolution to distribute the income of the trust by the end of the financial year. The time of the making of the resolution tells one nothing about the dominant purpose of a party in this case.*"[28]

6.18 Further, in rejecting the Commissioner's contention, regarding the change of financial position of persons connected with the taxpayer, that '*it was reasonably foreseeable that at the time the trustee decided not to exercise its discretion to "direct MHT's net income" to the special unitholders in the relevant years, LF's "financial position" would be negatively impacted because LF would have less retained earnings and a lower capital adequacy ratio*',[29] the Full Court noted:

'there is no evidence to support a conclusion that LF suffered a detriment beyond that obvious and necessary consequence. LF was remunerated by way of management and administration fees. LF continued to be profitable, solvent and maintained its credit rating in each of the relevant years. Its capital needs grew because its business grew and not because it had been deprived of distributions by MHT. At the same time, the schemes had real economic and financial consequences to Vesta and Jupiter. These factors point away from a party having the requisite dominant purpose.'[30]

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

(a) *The Commissioner's submission is not accepted.*

(b) *First, and most importantly, it discounts entirely the financial consequences to Vesta and Jupiter of the distributions made to them by MFGT which distributions would not have happened if MHT's income had been distributed to LF…*

(c) *Second, it fails to have regard to the totality of the circumstances including the fact that the Liberty group's business was growing. Additional debt and equity capital were raised by the group from 2016 to support that growing business…*

(d) *Third, the Commissioner's contention that the non-exercise of the discretion to distribute income to LF adversely affected LF's capital adequacy ratio and thereby put LF's credit rating at risk is not supported by the evidence. The evidence was that LF's credit rating improved from 2000 to 2014…*

(e) *…*

(f) *The evidence was that the non-payment of distributions to LF in the relevant years did not affect the solvency, profitability or credit rating of LF. LF had derived sufficient revenues to support its business needs in the relevant years. The changes in the financial position of LF as a result of the appellant's exercise of its discretion as trustee of MHT to distribute no more than a small amount to LF as special unitholder in the relevant years do not support a conclusion that a party entered into or carried out any of the schemes for the dominant purpose of obtaining a tax benefit.*

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

[28] *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 at paragraph [97]
[29] *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 at paragraph [103]
[30] *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 at paragraph [113]

Those same commercial outcomes would not have resulted if the MHT distributable income had been distributed to LF as the special unitholder. Contrary to the submissions of the Commissioner on appeal, it is not clear how LF would have been able to make equivalent distributions to Jupiter to reduce its indebtedness or to Vesta to enable it to increase its equity investment in MFGT and correspondingly increase MFGT's equity capital base.[31]

Decision Impact Statement

6.21 Despite the outcome in the Minerva Appeal, the Commissioner seeks to distinguish the facts of the case by noting that it involved a '*non-bank lender with an 'IPO ready' business structure*'.

6.22 They confirm that the '*decision does not disturb the Commissioner's long-held view that schemes which include a trustee's exercise of discretion to distribute income can attract the operation of Part IVA. Further, whether Part IVA will apply to such a scheme will not be answered by the trustee's evidence of their purpose. It will depend on a consideration of the 8 factors collectively applied to the objective facts, to ascertain whether a party to the scheme had the requisite objective purpose that the taxpayer would obtain a tax benefit*'.

[31] *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 at paragraph [112]

7 Tax consequences if the ATO deems a trustee distribution resolution to be invalid

7.1 Depending on the circumstances and the drafting of the trust distribution resolution, any of the following tax consequences may arise:

(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 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).

7.7 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."

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

7.9 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.

7.10 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.

Issue	***What can go wrong?***
The Who, What and When of Trust Distributions	
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.
Are the intended recipients beneficiaries of the trust? Are there any persons/groups of persons who are excluded as a beneficiary under the terms of the deed?	Confirm intended recipients are eligible to receive distributions from the trust. Common groups of persons who may be excluded as a beneficiary include, the Settlor and foreign persons. 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.
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).
Is there discretion to categorise and account income received as separate classes of income, specifically capital gains or franked distributions? Further, is there discretion to categorise and account expenses against separate classes of income and group classes of income? 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?	A broad review of the trust deed to ensure there are sufficient streaming provisions should be undertaken. 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).

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).
The Why of Trust Distributions	

Is there a distribution to a company?	Consider the operation of Division 7A and TD 2022/1.
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.
The How of Trust Distributions	
Has the trustee exercised 'real and genuine' consideration at the time of making the trust distribution	Failure to do so may enable challenges again a trust distribution by a disgruntled beneficiary.

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10 Disclaimer

10.1 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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