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Discretionary trust distribution resolutions – March, 2021

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

The legislative mechanics

"… where a beneficiary of a trust estate … is presently entitled to **a share** of the **income** of the trust estate … the assessable income of the beneficiary shall include … **that share** of the **net income** of the estate …""" [emphasis added].

(Section 97 *Income Tax Assessment Act 1997* (Cth))

- Note section 95 definition of **net income** meaning "the total assessable income of the trust estate calculated…as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions"

The legislative mechanics

- Note section 95 definition of **net income** meaning "the total assessable income of the trust estate calculated…as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions"
- Accepted section 97 means calculating proportion of income beneficiary entitled for trust law purposes and then apply the 'net income' in such proportions
- Note *Bamford* decision confirming 'proportionate' view

Trust law income

- Life beneficiary and remainder interest:
  - Life beneficiary benefits from income
  - Remainder interest benefitting from underlying capital
- Income v capital
- Sale of shares/property?

Trust law income

- *Clark v Inglis* [2010] NSWCA 144
- Annual asset revaluation of shares to market value and distributing gains to Dr Inglis
- Dr Inglis lent amounts back to discretionary trust
- Dr Inglis died and persons benefiting under his Will (second wife) differed from those beneficiaries of the trust (children from first marriage)
- Were unrealised capital gains income able to be distributed to Dr Inglis?

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Trust law income

- *Clark v Inglis* [2010] NSWCA 144 cont.
- Trust deed no definition of income
- Ordinary meaning of income under accounting standards
- Curiously on appeal, Allsop P adopted that 'income' encompasses both revenue and gains, and gains need not be realised
- Appears counter-intuitive, so commentary suggests to ensure there is a power in a deed
  - *Forrest v FCT* [2010] FCAFC 6 – trustee cannot wrongly classify a receipt as a capital gain when in truth it is income; which related to a hybrid trust
  - *FCT v Bamford* (2010) 240 CLR 481 where capital gains treated as income and *Cajkusic v FCT* (2006) 155 FCR 430 where trustee exercised power to classify outgoings as income or capital

Trust law income

- Trust law income as income defined under the powers of the trust deed
- Cases allow for the determination of what income is for trust law purposes, but requires an active determination
- What happens if these active determinations do not occur?
- Consider what the trust deed defines as income as a default position
- If claiming determinations made, is there sufficient evidence and does the deed allow oral determinations?
- *FCT v Trustee fofr the Michael Hayes Family Trust* [2019] FCAFC 226 – accounts accumulating income rejected as evidence as there were contrary evidence at hand

Trust law income

- Linking trust law income with tax law income (section 95)
- Common default position
- Income could include:
  - Capital gains
  - Franking credits
- Contrasted with Draft Tax Ruling 2012/D1 where ATO argues distributable income can only include accretions to the value of the trust deed so notional increases such as franking credits and market value substitution rule proceeds are not 'distributable'

Trust law income

- Proportionate approach
- Trust law income proportion applied proportionate for tax
- Distributions proportionate or precise amounts?
- If there's differences between trust law income and tax law income, then consider flow on effect

Trust losses

- Power in trust deed to carry forward losses?
- Authority that otherwise profits must be offset against losses – *Upton v Brown* (1884) 26 Ch D 588; *Re Reynolds* [1942] VLR 158
- Note *Raftland v FCT* (2008) 238 CLR 516 with contrary position
- Avoid doubt, and ensure power exists if required to utilise

Streaming

- Prior to 1 July 2010, no legislative streaming provisions
- Following amendment to legislation, streaming is possible (from a tax perspective) for franked dividends and capital gains
- Note, no ability to stream franking credits separate to dividends – *Thomas v FCT* (2018) 264 CLR 382
  - Note while accepted possible from a trust law perspective
  - Ambiguity how it would pan out from a tax perspective (still a proportionate approach)
- Post 1 July 2010, legislation provides a mechanism to remove capital gains and dividends from the proportionate ambit of all the usual income

Streaming – capital gains

- Required to be made specifically entitled
  - Beneficiary need have received or can be reasonably expected to receive
  - Recorded in its character as referable to a capital gain in the accounts no later than 2 months after the end of the income year
- Making sure capital gains flow with who will receive it means ensuring any amounts of capital gains not distributed as part of an income distribution flows under some other form of distribution
- E.g. Income is section 95 income and the 50% CGT discount is applied
  - Income only includes half the capital gains
  - A separate company distribution need be made to ensure the beneficiary receives the specifically entitled component

Streaming – franked dividends

- Ensuring relevant expenses applied against franked distributions
- Noting that the legislation allows the aggregation of two or more franked distributions, particularly where one source of franked distributions exceeded due to relevant expenses (which could result in potentially franked amounts being able to be distributed (?))

Streaming – big picture

- Rental income - $100,000
- Dividend - $70,000
- Franking credit - $30,000
- Relevant expense for dividend – ($100,000)
- Taxable income - $100,000
- Where does the franking credit go?
- Does anything change if relevant expense for dividend is ($90,000)?

Trustee resolution drafting

- Qualification re: Chat Legal resolutions
  - Helpful to find relevant clauses in deed to link power
  - How to prepare resolution requires thought on which powers to exercise and use
- Trust-wise, *could* be possible to distribute post-30 June but due to adverse tax implications if present entitlement is not known, most deeds require resolutions be 30 June to make beneficiaries presently entitled
- While there were old concessions available (allowing a 2 month window) – they were removed on 1 September 2011

Trustee resolution drafting

- Dating of resolution/minute after 30 June?
  - Provided evidence and provable that trustee made determination by 30 June
  - Provided trust deed allows for such mechanisms
- Picking the 'best approach'
- Being too precise can be 'suss'
- Reverse engineered trust distributions?
  - '*…an amount of trust income (to the maximum extent it is available) that would ensure that Zac's total taxable income for the 2019 income year does not exceed $80,000*)
  - Again, potentially possible under trust law
  - But under tax law and the mechanisms, present entitlement may not be identifiable

Trustee resolution drafting

- Proportionate
- Fixed amounts
- Combination
- What's best, depends on your client's circumstances
- Cannot bulletproof for all possible scenarios

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Other wording?

- *"$50,000 to each of X and Y and if the Commissioner of Taxation adjusts the net income of the trust, that amount to Z Co"*
- *"The first $50,000 to X, the next $50,000 to Y and the balance of the income to Z Co"*
- *'To Beneficiary A that percentage of income that, when multiplied by the taxable income of the trust, equals $X'*

Later adjustments / failed distributions

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- Falls to a 'catch-all' clause?
- Falls to default beneficiary?
- Disclaimers?
- *'Does the beneficiary's interest remains subject to a contingency at the end of the income year?'*
  - In light of having two separate distribution amounts depending on the value of the trust's taxable income for the year

Other issues to consider

- *Greensill* – foreign beneficiaries
- 100A
- Valid beneficiary
- Distributions required for 'small business capital gains tax concessions' to satisfy significant individual require (?)
- Division 7A

Usual issues to consider

Contact details

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