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Trust distributions 101 – August 2021

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

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Foundations

- Trust not a legal entity
- Relationship between
  - Personal legally holding assets (Trustee)
  - For the benefit of other person/s (Beneficiaries)
- Look-through treatment
- *Income Tax Assessment Act 1997* (Cth) defines entity to include a 'trust' (section 960-100)

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Structure of a trust

- Person who manages the asset of the trust – Trustee
- People who can benefit from the income and capital of the trust – Beneficiaries
  - Fixed (regardless what happens)
  - Discretionary (at the discretion of the Trustee)
  - 'Default' (benefits where the Trustee does not make a decision)
- Person who can replace the Trustee – Appointor/Principal/Guardian/Protector
  - Role may also require Trustee to consult this person
- Person who creates the trust – Settlor
  - Unrelated person – section 102 *Income Tax Assessment Act 1936*
- Precisely what each role does depends on the terms of the trust deed

Requirements of a trust

- Three certainties
  - Certainty of intention (i.e. there was an intention to create a trust over property)
  - Certainty of subject matter (i.e. the property of the trust must be specified with certainty)
  - Certainty of object (i.e. the beneficiaries or objects of the trust must be sufficiently identifiable)
- Failure to have any of the above results in there being no technical trust
- Trust deed provides clarity as to the above certainties:
  - States settlor's intention to create trust pursuant to certain terms
  - States what constitutes the 'Trust Fund' assets
  - States who benefits from the trust with sufficient identifiablity

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Trust deed

- Relationship governed by rules (trust deed)
- Deal with assets? Trustee powers
- Deal with income or capital? Distribution powers
- Change the Trustee or other roles? Succession powers
- What happens if certain events happen to key persons? Default positions included
- Want to update document? Variation powers

Beneficiaries

- Family group
  - Direct
  - Broader (cousins, uncles and aunties)
  - Trusts and companies
  - Charities
- Excluded beneficiaries:
  - Settlor
  - Trustee
  - Former trustee
  - Persons who have gifted property into the trust
  - Foreign persons
  - Persons not in a family group
  - Trusts that vest after distributing trust
  - People on Centrelink and their 'associates'

What is income

- Ordinary concept?
- Accounting concept?
- Taxation concept?
- What is a capital gain?
  - Gross capital gain?
  - Net capital gain?
- Distinction between what the Trustee can distribute as income from the trust and what is income under taxation concepts

Discrepancies

- Capital gains made
- Depreciation
- Different years in which capital gains/proceeds made/finalised

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Dealing with the mismatch

- *Commissioner of Taxation v Phillip Bamford & Ors* [2010] FCA 10
  - 2000 income year
    - Distribute $34,000 to Mr and Mrs Bamford with the balance of income to the Church of Scientology.
    - Subsequently found certain deductions claimed were not allowable under the tax law.
    - Resulted in 'Net Tax Income' exceeding the 'Trust Income'.
    - Taxpayers argued they should only be taxed on income distributed (Trust Income).
    - Commissioner argued that excess income should be taxed in proportion to recipients of Trust Income.
  - 2002 income year
    - Only taxable income derived was a net capital gain. No other Trust Income derived.
    - Trust Income not defined but allowed trustee to include capital gain in Trust Income.
    - Taxpayer sought to exercise power to include capital gain in Trust Income, however, Commissioner argued Trust Income definition was fixed to ordinary concepts.

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Dealing with the mismatch

- *Commissioner of Taxation v Phillip Bamford & Ors* [2010] FCA 10
  - Regarding 2000 income year – High Court confirmed proportionate approach adopted by Commissioner was the correct approach to adopt in determining a beneficiary's shares of 'Net Tax Income' of a trust.
  - Regarding 2002 income year – High Court determined concept of Trust Income takes its meaning from trust law – that is dependent on the terms of the trust deed.

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Dealing with the mismatch

- ATO's view following *Bamford*:
  - Concepts of Trust Income and Net Tax Income are two different matters which do not necessarily correspond.
  - 'Income of the trust estate' (per section 97 1936 Tax Act) takes meaning from general law of trusts and not from taxation law.
  - Under 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.
  - 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.
  - The 'proportionate approach' applies in determining a beneficiary's share of the trust's Net Tax Income.
  - The proportionate approach is a mathematical calculation based on applying the percentage share that a beneficiary is presently entitled to Trust Income, to the trust's Net Tax Income.

Take-outs

- Read the deed
- Consider what is being distributed
- Consider if trust deed allows you to make such distribution (see next slides for examples)
  - If not, any changes required or alternatives possible?

Example scenarios

- $100,000 trading income
- $1,000,000 capital gain
- Want to distribute capital gain to Wife
- Want to distribute trading income as follows:
  - $20,000 to Mum
  - $20,000 to Dad
  - $60,000 to Bucket Company

Trust deed definitions

- Income equals accounting income
  - Does not include capital gains ordinarily
- Income equals section 95 *Income Tax Assessment Act 1997* definition of net income
  - Includes net capital gains but does not include disregarded capital gain
- Income equals such amount as determined by trustee
  - Includes such amount of capital gain as decided

Streaming

- Prior example did not consider ability to allocate capital gain to Wife
- Note changes to law following *Bamford* allowing certain classes of income to be separately dealt with form a tax circumstance
- Prior rules did not distinguish between classes
- Further, *Bamford* suggested that streaming not possible from a tax perspective as tax flowed in proportion to distributed income – therefore needing legislative amendments
- *Taxation Laws Amendment* (2011 Measures No. 5) Act 2011
- Subdivision 115-C (capital gains) and 207-B (franked dividends)
- No specific legislation in relation to streaming of other classes of income (at tax law).

TLAM 2011

- Process for streaming:
  - Start with each beneficiary's shares of the trust income
  - Determine amounts of capital gains and franked distributions to which beneficiaries are **specifically entitled** and their respective percentage
  - Apply relevant subdivisions to assess beneficiaries on their share of the capital gain or franked distribution derived
  - Apply Division 6E to adjust taxable income amounts otherwise assessed to a beneficiary
- Any capital gain or franked distribution which no beneficiary is specifically entitled to will be allocated proportionately under the ordinary income distribution
- **Specifically entitled** means ensuring target beneficiary is to be entitled to such capital gain or franked distribution utilising trust deed powers

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Practical impact of streaming

- In order to successfully stream, steps must be taken to ensure relevant beneficiaries are made specifically entitled to such streamed component
- This may rely on utilising powers to make distributions of income or capital
- Alternatively, where fixed trusts are involved, such interest-holders are deemed specifically entitled in accordance with their proportions
- Care must be taken with capital gains as capital gains could (depending on the definition of income in the trust deed) be split between income and capital (for example, where 'income' only means 'net income' – being assessable income)

Capital gains and trust income

- **Capital gain is income**: The gross capital gain is automatically included in the meaning of Trust Income under the terms of the trust deed or the trustee has discretion to do so – in which case the trustee should ensure that the capital gain is characterised as forming part of the Trust Income, and separately identified as a particular class of income, to which the intended beneficiary is entitled. The trustee would then resolve to distribute the gross capital gain to the beneficiary using its income distribution power.

- **Capital gain is not income**: The gross capital gain is not included in the meaning of Trust Income under the terms of the trust deed and the trustee has no discretion to do so – in which case the trustee should ensure that the capital gain is separately dealt with as a capital distribution, for example as an interim distribution of trust capital, to the intended beneficiaries

- **Some capital gain is income:** Only part of the gross capital gain is included in the meaning of Trust Income under the terms of the trust deed (e.g. Trust Income is defined to mean section 95 net income) – a common example of this situation is where the trust derives a capital gain subject to the 50% CGT discount. Since only 50% of the gross capital gain is included in Trust Income the trustee can only make a beneficiary specifically entitled to 50% of the gross capital gain under the trustee's income powers. To ensure that the intended beneficiary is specifically entitled to 100% of the gross capital gain, the trustee would need to use its capital distribution powers to distribute the remaining 50% of the gross capital gain to the intended beneficiary.

Other miscellaneous considerations

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- Whether ability to determine income
- Whether ability to classify/reclassify income
- Whether ability to treat income into separate classes
- Whether ability to deal with separate classes of income
- Whether consent required prior to distributing income/capital
- When distributions must be made (midnight, 5.00pm, day before)
- Whether prior year trust losses are offset against current year income or not

No standard template

- Every client and every trust deed (once combined) by mean that there is no one solution
  - Terms of trust deed
  - Trust assets
  - Client circumstances
- Read the deed
  - Refer to the correct powers
  - Risk failed distributions otherwise

No standard template

- Every client and every trust deed (once combined) by mean that there is no one solution
  - Terms of trust deed
  - Trust assets
  - Client circumstances
    - Fixed sum
    - Proportionate
- Read the deed
  - Refer to the correct powers
  - Risk failed distributions otherwise

Failed trust distribution

- Default beneficiary
- Remainder on trust distribution resolution
- Beneficiary renouncing interest
  - Impact?

Dealing with distributions

- Presently entitled
  - Unpaid present entitlements
- Section 100A
- Powers in trust deed to allow:
  - Such amounts to be held on sub-trust:
    - Ability to intermingle
  - Such amounts to be held as a loan:
    - Where beneficiary is a company

Contact details

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