

Discretionary Trust Distributions

The discretionary trust continues to grow in popularity, both as a vehicle for conducting business or business-related activities and for holding appreciating capital assets, and as a result practitioners are increasingly required to facilitate their operation. Attending to a discretionary trust requires that practitioners exercise diligence and care to ensure that each trust is handled appropriately, to best advantage, and having regard for the terms of each particular trust deed and the relevant provisions of the applicable law. The following is an up-to-date guide to practitioners on the factors that need to be considered when making an annual distribution of income of a discretionary trust in light of recent developments in this area of law, particularly the High Court's significant decision in *FCT v Bamford* [2010] HCA 10.

The Discretionary Trust Deed

It must first be noted that the style and content found among discretionary trust deeds varies enormously. What is referred to in this article as a discretionary trust should be understood as a typical discretionary trust which is a resident for tax purposes, but other types exist- such as hybrid trusts- which are not considered here. Care must be taken above all to understand the provisions of a particular trust deed, without making assumptions about the way a trust deed operates. This will safeguard against costly mistakes.

Case law in this area indicates that if action is taken otherwise than in accordance with the terms of the trust deed, the result may be contrary to what was sought to be achieved. For example, if a distribution of income does not comply with the time limits set out by the deed, it may prove ineffectual or worthless (*BRK (Bris) Pty Ltd v FCT* ([2001] FCA 164). Practitioners must also be familiar with provisions of the relevant *Trustee Act* which relate to the operation and management of t discretionary trust.

Trustees of a discretionary trust and practitioners must consider and be familiar with a number of significant aspects of the discretionary trust deed. These include:

- Any time limits with which the trustee must comply in order to validly exercise discretion to distribute income for an accounting period;
- Any consent or approval required by the trustee in order to act under the trust deed;
- The beneficiary class for incomes, and corpus;
- Any events that have affected the beneficiary class, such as death or divorce;

- Any power of the trustee to add or remove beneficiaries, and whether that has been exercised;
- Any acts by the beneficiaries to disclaim their entitlements under the trust deed, or exercise their right under the trust deed to be excluded from benefitting under the deed;
- The definition of income under the deed, including powers and discretions under the deed;
- Any provisions governing what the distributable income is for an accounting period and what, if anything, needs to be done to satisfy this, including the time by which it must be done;
- Whether the income for an accounting period can be accumulated by the trustee;
- Whether there is a default income provision, and its effect in the case of a failure to effectively distribute income for an accounting period;
- Any actions the trustee must take under the trust deed to ensure that a beneficiary is presently entitled to income for an accounting period, including what actions must be taken to deal with capital gains or derived income to which special characteristics attach;
- Any streaming provisions under the trust deed;
- Any amendments that have been made to the trust deed, and their implications.

Problems can frequently arise with the construction of trust deed provisions. In interpreting any particular provision, practitioners should take into account the whole of the trust deed, as well as any interpretive provisions, and any statutory provisions which have bearing under the deed. More information on the issues that need to be considered before making a distribution can be found in the Taxation Institute of Australia's 2010 publication 'Discretionary Trust Distributions: the essential practitioners' manual post *Bamford*'.

Preparing to Distribute Trust Income

Once familiar with the trust deed or instrument, the trustee of a discretionary trust may then prepare to make a distribution of the trust income for an income year. The trustee must first determine when the distribution must be made. To be effective for income tax purposes, a distribution by a trustee of the income of a discretionary trust for an income year must be made by the last day of the income year (30 June) or by an earlier time if an earlier time is prescribed in the trust deed. By this time, the trustee must make the distribution, and also any determination or resolution relating to calculating or streaming income under the deed. Delays should be avoided, and corrected immediately on discovery.

In preparing to distribute the income of a discretionary trust for a trust year, the trustee must also seek any necessary consent or approval as required by the trust deed and take into account any previous distributions made in that income year. If the trust is a specific type, such as testamentary trust, a family trust or child maintenance trust, the trustee should take into account any special conditions that apply. Likewise, if the beneficiaries are of a particular category, such as minors, companies, or trusts, the trustee must consider any implications of this.

The trustee should also consider whether there are any income tax or CGT considerations that would mean a particular distribution should or should not be made, including the effect of the small business

CGT concessions and the trust loss provisions. Further, if the trust deed permits accumulation of income, the trustee should consider circumstances where accumulation of some or all of the income is warranted. The trustee must identify the amounts received and paid during the income year and determine whether these are assessable income or allowable deductions for income tax purposes.

Finally, the trustee must consider if the net tax income of the trust will exceed the income of the trust (the distributable income) for the income year, and if so, identify any action that can be taken under the trust deed. If the income of the trust deed will be nil or negative, the trustee must identify any action that can be taken to avoid the trustee being assessed on the net tax income, such as treating another amount as income.

Making the Trust Income Distribution

When considering the necessary documentation to effect a distribution of trust income, and the form it should take, the provisions of the trust deed must again be carefully considered. Some discretionary trust deeds specify a form or procedure for making a distribution, while others do not.

The distribution resolution should deal with the whole of the income of the trust estate for the income year by either distribution or accumulation (if allowed under the deed). Income not dealt with in the distribution resolution will usually be governed by a default provision. If the amount is not precise because the income is not entirely known, or some oversight is made in determining it, it is sufficient if the amount distributed is ascertainable from the trust accounts when prepared. The Commissioner may later make an adjustment to the way the distribution is taxed, if appropriate. Distribution of the whole income can be achieved by distributing in percentages to make a whole; distributing in fixed dollar amounts, plus the “balance”; or distributing fixed amounts, to be adjusted on a pro rata basis if the income is greater or less than the total distributed.

The distribution resolution should have the effect of immediately and irrevocably vesting a specific portion of the income of the income year in the beneficiary, thus making it an effective distribution in favor of the beneficiary. The High Court has accepted that (statutory provisions apart) a beneficiary will be presently entitled to income of a trust estate if, and only if:

1. the beneficiary has an interest in the income which is both vested in interest and vested in possession; and
2. the beneficiary has a present legal right to demand and receive payment of the income, whether or not the precise entitlement can be ascertained before the end of the relevant income year and whether or not the trustee has the funds available for immediate payment (Harmer v FCT [1991] HCA 51; 91 ATC 5000; FCT v Bamford).

For the purposes of the ITAA 1936 and the ITAA 1997, where a trustee has a discretion to pay or apply income of a trust estate to or for the benefit of specified beneficiaries, a beneficiary in whose favour the trustee exercises the discretion is deemed to be presently entitled to the amount paid to the

beneficiary, or applied for the beneficiary's benefit, by the trustee in the exercise of the discretion (sec 101 ITAA 1936). It would seem that the reference to "income" would be a reference to what constitutes "the income" of the trust estate for the purposes of sec 97 ITAA 1936 (that is, income according to trust principles and the terms of the trust deed (*FCT v Bamford*)). Where the circumstances are such that the terms of sec 101 ITAA 1936 are met, the beneficiary would, in any event, usually be presently entitled to the income within the meaning of sec 97 and 98 ITAA 1936.

Cautionary Notes

DIV 7A implications

If the income of a discretionary trust is to be distributed to a beneficiary which is a private company, the trustee should consider the possible implications of Div 7A ITAA 1936. Of particular concern are the company loan rules provisions of Div 7A which deem as dividends any loans made to associates of shareholders of a private company. This year, the Commissioner issued a ruling which sets out his views on the circumstances in which a private company that becomes presently entitled to an amount from an associated trust will be taken to have made a loan to the trust for the purposes of Div 7A (TR 2010/3). This ruling is significant because it extends the circumstances in which a private company will be taken to have made a loan to the trust beyond the circumstances in which it was previously thought that a loan would be made. The Commissioner also released a draft practice statement on 2 June 2010, the final form of which will provide practical guidance on the administrative aspects of the ruling.

The view is taken in TR 2010/3 that, given the legislative context of Div 7A ITAA 1936, an amount that has been treated as a loan and dealt with under sec 109D ITAA 1936 should be regarded as a loan for all purposes of Div 7A ITAA 1936, including the trust provisions of Subdiv EA. Accordingly, the Commissioner will not treat an unpaid present entitlement (UPE) that is subject to the view in TR 2010/3 and is considered to constitute a Div 7A ITAA 1936 loan as a present entitlement that remains unpaid for Subdiv EA purposes.

Defining 'Income'

The recent High Court decision in *FCT v Bamford* establishes that "the income of the trust estate" for the purposes of Div 6 ITAA 1936 is determined by reference to the principles of trust law, as affected by the provisions of the particular trust deed. This means that the "income" (also called "net annual income") of a discretionary trust would usually be "the income of the trust estate" for the purposes of Div 6 ITAA 1936. This is sometimes referred to as the distributable income of the trust.

Before making any decision as to the distribution of the income of a discretionary trust, the trustee must consider what the income of the trust for the income year is likely to be (based on incoming and outgoing amounts throughout the year). The trustee will need to consider if and how the trust deed defines "income" and whether the trust deed confers any power or discretion as to what the income is.

It is, of course, also necessary for the trustee to have regard to what the net tax income of the trust will be (or be likely to be) and what the net tax income will be comprised of. This is primarily because the amount that is brought to tax pursuant to the provisions of Div 6 ITAA 1936 is the net tax income for discussion of the net tax income.

An important reason why it is necessary to consider what the trust income and the net tax income of a trust are for an income year is to identify and, if necessary, deal with problems that might arise if the trust income (without anything permitted by the trust deed being done) would be a different amount to the net tax income for the income year.

Usually, of course, the actual amount of the income or of the net tax income of a trust for an income year will not be known by the time a distribution resolution is made. The trustee must, however, identify any possible reasons that would necessitate some special action being taken and, if necessary, take the action in a timely manner to ensure that the distribution made will be effective.

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