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Trust Resolutions – Relevance & Application

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Trust Resolutions – Relevance & Application

Presented by Brian Richards

Introduction

There are many instances where the manner of drafting trust resolutions to appropriate income or capital of the trust is a critical factor in achieving the desired tax outcomes. These instances include inter alia:

1. Appropriating the trust income to the relevant beneficiaries;
2. Streaming trust income to specific beneficiaries;
3. Making a beneficiary specifically entitled to a capital gain of the trust;
4. Determining whether the unpaid entitlement is an equitable obligation (UPE) or debt; and
5. Making a beneficiary absolutely entitled to a trust asset.

As we acknowledge, the primary source of authority to facilitate all of the above instances is the trust deed. For the purposes of this presentation, the Acis Discretionary Trust Deed will be used to illustrate the practical requirements.

There have been many recent taxation rulings, determinations and court decisions which provide guidance on what constitutes the parameters for the above practical instances. For example:

Cases:

- FCT v Bamford [2010] HCA 10
- FCT v Greenhatch [2012] FCAFC 84
- Thomas v FCT [2018] HCA 31
- Lewski v FCT [2017] FCAFC 145

Rulings:

- TR 2004/D25
- TR 2010/3
- TR 2012/D1

Determinations:

- TD 2012/22

Present-day case decisions often involve difficult and complex areas of law that have limited application to the advice provided by accountants and lawyers in dealing with their small business clients. **However**; what is obvious from the above cases and ATO rulings, is that they address everyday matters. Accordingly, it is imperative that advisers have a thorough understanding of the practical implications of these cases.

In the same practical context of what needs to be addressed with discretionary trusts, the importance of trust resolutions is fundamental to the application of Division 152 ITAA 1997, for example:

1. What income and/or capital is;

2. Which, if any, entity is connected to the trust is determined, inter alia, by prior year trustee distributions; and

3. Which individual is a CGT concession stakeholder of an entity is determined by the individual's entitlement to trust income and/or capital in the relevant year of the CGT event (the small business participation percentage).

Trust resolutions

There are some well accepted imperatives in dealing appropriately with the process of distributing the trust income for a particular year:

1. Determination as to what constitutes trust income;

2. The resolution must make the beneficiary presently entitled to the trust income; and

3. The beneficiary must be presently entitled to the trust income no later than the 30th June each year.

With regard to the above, a brief review of the relevant case law will highlight the relevant factors.

1. What is trust income?

If there was any uncertainty about the term "income of the trust" when used in section 97 ITAA 1936, the decision in **FCT v Bamford [2010] HCA 10** (**Bamford**) clarified the meaning of that term. The Court made the following reference:

> *The very juxtaposition within s 97(1) of the defined expression "net income of the trust estate" and the undefined expression "the income of the trust estate" suggests that the latter has a content found in the general law of trusts, upon which Div 6 then operates.*

To the extent that the general law of trusts is the applicable determinative, there are two essential factors:

(a) To what extent does the trust deed define what constitutes the "income of trust"; or

(b) If the deed does not define what constitutes the income of the trust, the income of the trust will be determined by what is income according to the "ordinary concepts".

So much is provided by the High Court's rejection of the Commissioner's proposition that:

> *..., the Commissioner considered that the capital gain was not included in "the income of the trust estate" of which s 97(1) speaks, with the result that there was no income of the trust estate to which s 97(1) could apply and that the Trustee itself was to be assessed under s 99A of the 1936 Act.*
>
> *In this Court the Commissioner submits, contrary to the decision of the Full Court, that "the income of the trust estate" did not include this amount. This is said to be so because, while available for distribution in accordance with the Deed, the capital gain amount was not, in the sense of the 1936 Act, "income according to ordinary concepts".*

That is, as distinct to the term "net income of the trust" which is specifically defined by section 95 ITAA 1936, the term "income of the trust" will, where applicable, take its meaning from the terms of the trust or, in the absence of a definition, the ordinary meaning of the word "income".

Far from being merely an academic issue, the power of the trustee to define what constitutes the income of the trust is very relevant to the following practical circumstances:

(a) The attribution provisions of the trust deed, which invariably allow the trustee to differentiate types of income and capital;

(b) The trust streaming rules – in particular subdivision 115-C ITAA 1997; and

(c) Differentiating between capital and income distributions for the purposes of identifying whether an individual satisfies the small business participation test in section 152-70 ITAA 1997 (item 3).

It will be noted that the Acis deed provides to the trustee:

(a) The prerogative to rely on the deed's stipulated definition of trust income; and

(b) The power to specifically define what will constitute the trust income for a particular year.

1.1 Acis deed's definition of "income"

The current Acis deed defines the trust's income in the following manner:

> ***Income*** *means at any relevant time:*
>
> *(a) the net income of the Trust as defined in section 95 of the Act excluding Notional Amounts; or*
>
> *(b) the income of the Trust determined by the Trustee using any other method selected by the Trustee which (for the avoidance of doubt) may include gross income or a determination based on ordinary concepts of trust income or on generally accepted accounting principles or on any other method or any combination of methods determined by the Trustee and in any case, the Trustee may, at its discretion, include in or exclude Notional Amounts;*

Note further that the trust deed defines the term "notional amounts" in the following manner:

> ***Notional Amounts*** *means:*
>
> *(a) notional amounts or credits which are included as income for the purposes of the Act but not actually paid or payable to the Trustee;*
>
> *(b) income or credits in the nature of income (including, without limitation, tax off-sets or franking off-sets);*

The above definition of "income" provides the trustee significant flexibility in defining what constitutes income. Examples of where the above definition will be of practical importance to the trustee is illustrated later with the streaming discussion where, inter alia, the trustee might determine what capital gain might be treated as trust income or capital for the purposes of trust distributions – noting that irrespective of what the trustee determines to be income or capital does not impact the calculation of the section 95 ITAA 1936 term "net income".

Relevantly, taxation ruling **TR 2012/D1** (meaning of "income of the trust estate" in Division 6 of Part III of the Income Tax Assessment Act 1936 and related provisions) is still very much a pertinent draft ruling, in dealing with what constitutes trust income that is capable of distribution for the purposes of section 97. The ruling saliently notes that:

> *12. In the context of Division 6, the '**income of the trust estate**', is not a reference to the gross income of a trust estate, but rather a reference to the net amount of income to which a beneficiary could be made presently entitled or accumulated. That is, it is a reference to the*

__income available for distribution__ to beneficiaries or accumulation by the trustee, commonly referred to as 'distributable income'.

13. Notwithstanding how a particular trust deed may define income, the 'income of the trust estate' for Division 6 purposes must therefore be represented by a net accretion to the trust estate for the relevant period. In effect, the statutory context places a cap on what the income of the trust estate may be for Division 6 purposes. Specifically, for these purposes, the income of a trust estate for an income year cannot be more than the sum of:

- *the accretions to the trust estate (whether accretions of property, including cash, or value) for that year;*
- *less any accretions to the trust estate for that year which have not been allocated, pursuant to the general law of trusts (as that may be affected by the particular trust instrument), to income [and therefore cannot be distributed as income]; and*
- *less any depletions to the trust estate (whether depletions of property, including cash, or value) for that year which, pursuant to the general law of trusts (as that may be affected by the particular trust instrument), have been allocated as being chargeable against income.*

The relevance of the term "distributable income" is a fundamental factor in understanding the relevance of the draft ruling's dealing with notional amounts. Other than the conjecture whether franking credits are properly treated as "notional income" in the context of the Commissioner's description of what constitutes trust income, an easy example is where the trust has made a capital gain as a consequence of a gifting of a CGT asset.

1.2 Example

If the trustee gifted a CGT asset to an entity for no consideration, the capital proceeds for the CGT event will be based on the market value of the asset at the relevant date (section 116-30ITAA 1997), say $10,000.

Assume the asset has a cost base of $5,000.

Pursuant to CGT event A1, the assessable capital gain will be $5,000.

Now, assume the asset was acquired more than 12 months prior to the CGT event. Accordingly, the net capital gain (section 102-5) after allowing for the Division 115 CGT discount will be $2,500.

If the income of the trust refers to the section 95 "net income", the trust income is $2,500.

However, can the trustee actually distribute that trust income where there are no proceeds received? The draft ruling provides at paragraph 118:

> *Section 116-30 of the ITAA 1997 sets out the circumstances in which the proceeds from a CGT event are reduced or increased (as appropriate) to equal the market value of the CGT asset that is the subject of the CGT event. The modifications made by section 116-30, where they treat the trustee as having received a greater amount of capital proceeds than that which was actually received, will not result in any matching accretion in the trust fund.*

Consider the alternative trust situation where a beneficiary has obtained an absolute entitlement to a trust CGT asset. In this situation, and only if the beneficiary has obtained an absolute entitlement to a trust asset, CGT event E5 applies.

CGT event E5 does not rely on the market modification rule to determine the trust's assessable capital gain (refer to section 104-75(3)). In this regard, ATO ID 2013/33 dealt with whether a

beneficiary could be specifically entitled to a capital gain where CGT event E5 applied. The ATO ID provides that:

> ***Issue***
>
> *Can a beneficiary be specifically entitled to a capital gain made by the trustee of a trust by reason of the happening of CGT event E5 in section 104-75 of the Income Tax Assessment Act 1997 (ITAA 1997)?*
>
> ***Decision***
>
> *Yes. If a trustee of a trust makes a capital gain by reason of CGT event E5 when a beneficiary becomes absolutely entitled to an asset of the trust, the beneficiary can be specifically entitled to the gain.*

More importantly, in support of that determination, the ATO ID states in relation to section 115-228 that:

> *Section 115-228 of the ITAA 1997 sets out when a beneficiary will be regarded as specifically entitled to a trust capital gain (either in whole or in part). To be specifically entitled to the whole gain, one requirement is that the beneficiary must have received, or can reasonably expect to receive, in accordance with the terms of the trust, all of the financial benefit referable to the capital gain (paragraphs (a) and (b) of the definition of 'share of net financial benefit' in subsection 115-228(1) of the ITAA 1997). Another requirement is that the financial benefit be recorded, again in accordance with the terms of the trust, in the accounts or records of the trust in its character as referable to the capital gain (paragraph (c) of the definition).*
>
> *The issues in this case are:*
>
> - *whether a beneficiary can be said to have received or be expected to receive all of the financial benefit referrable to a capital gain in a situation where the capital gain arises because the beneficiary has been made absolutely entitled to a trust asset as against the trustee and the quantum of the capital gain is worked out by reference to the market value of the asset; and*
> - *whether the financial benefit that the beneficiary has received or can be expected to receive has been recorded in the accounts or records of the trust in its character as referable to the capital gain.*
>
> *As to the first issue, the Explanatory Memorandum to the Bill that on enactment introduced section 115-228 of the ITAA 1997 stated:*
>
> > *2.59 [W]hether a beneficiary can be specifically entitled to a capital gain or franked distribution is a question of fact. For example, when a beneficiary becomes absolutely entitled to a trust asset, it may be reasonable to expect the beneficiary will receive the net financial benefit referable to the deemed (trust) capital gain from CGT event E5.*
>
> *In this case, the financial benefit referable to the capital gain is the asset itself (or the value of that asset) and the absolutely entitled beneficiary is, in accordance with the terms of the trust created by the will, the only one that is expected to receive the asset (and thus that benefit).*
>
> *As to the second issue, the Explanatory Memorandum stated:*

> *2.63 The accounts or records of the trust would include the trust deed itself, statements of resolution or distribution statements, including schedules or notes attached to, or intended to be read with them. However, a record merely for tax purposes is not sufficient.*

In this case, the will which created the trust meets the description of a record of the trust in which is recorded the financial benefit that the daughter is expected to receive in its character as a benefit referable to the capital gain - the will records the daughter's absolute entitlement to the asset.

It follows that the absolutely entitled beneficiary will be regarded as specifically entitled to the capital gain that arose from CGT event E5 happening to the shares. It also follows that no portion of the gain falls to be assessed to the life tenant.

To the extent that the ATO accepts that the asset transfer pursuant to a CGT event E5 situation satisfies the section 115-228 requirement that a beneficiary receives the financial benefit related to the notional gain (based on a market value substitution by section 104-75 vis a vis section 116-30), the question is: Why is there a different outcome where the gain is a notional gain calculated pursuant to the application of section 116-30?

Needless to say, the essential factor is whether the beneficiary receives an absolute entitlement to the CGT asset. Refer to draft taxation ruling **TR 2004/D25**, which provides that the term absolute entitlement involves:

Core principle

10. The core principle underpinning the concept of absolute entitlement in the CGT provisions is the ability of a beneficiary, who has a vested and indefeasible interest in the entire trust asset, to call for the asset to be transferred to them or to be transferred at their direction. This derives from the rule in Saunders v. Vautier applied in the context of the CGT provisions. The relevant test of absolute entitlement is not whether the trust is a bare trust.

Rule in Saunders v. Vautier

11. Under the rule in Saunders v. Vautier, the courts do not regard as effective a direction from the settlor of the trust that purports to delay the beneficiary's full enjoyment of an asset. However, if there is some basis upon which a trustee can legitimately resist the beneficiary's call for an asset, then the beneficiary will not be absolutely entitled as against the trustee to it.

The draft ruling later states that:

Discretionary trusts

*71. Because an object of a discretionary trust does not have an interest in the trust assets, they cannot be considered absolutely entitled to any of the trust assets **prior** to the exercise of the trustee's discretion in their favour.*

---

2. Present Entitlement

2.1 Section 97 ITAA 1936

Perhaps the more contentious technical aspect of section 97 ITAA 1936 concerns the term "present entitlement".

Beneficiary not under any legal disability

(1) Subject to Division 6D, where a beneficiary of a trust estate who is not under any legal disability is presently entitled to a share of the income of the trust estate:

> *(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; and...*

There are a number of aspects of the term "present entitlement" that have attracted recent attention, including:

(a) What is required to make a beneficiary presently entitled to the trust appropriation, albeit income or capital;

(b) What can a beneficiary be presently entitled to;

(c) What flexibility can be drafted into a trustee resolution to cover all of the contingencies that the trustee might contemplate at the time of drafting the distribution resolution; and

(d) The relevance of default income clauses.

2.2 Vested and indefeasible

The legal requirements to make a beneficiary presently entitled to a trust amount is best illustrated by the Court in **Harmer v FCT [1991] HCA 51**, to be pertinent:

> *8. The parties are agreed that the cases, see, in particular, Federal Commissioner of Taxation v. Whiting (1943) 68 CLR 199, at pp 215-216, 219-220; Taylor v. Federal Commissioner of Taxation (1970) 119 CLR 444, at pp 450-452; establish that a beneficiary is "presently entitled" to a share of the income of a trust estate if, but only if:*
>
> *(a) the beneficiary has an interest in the income which is both vested in interest and vested in possession; and*
>
> *(b) 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 year of income and whether or not the trustee has the funds available for immediate payment.*

Of particular relevance is the latter point, namely that a beneficiary is regarded as presently entitled **if** the beneficiary has a present legal right to demand and be paid the entitlement.

However, where a contingency exists, as distinct to a mere deferral of the timing of payment, the beneficiary will not be presently entitled. As stated by the Court:

> *If some person or persons were presently entitled to the corpus or income before payment in, the fact of payment in to await the orders of the court will not, of itself, displace that present entitlement. If entitlement is disputed, the function of the court will be to identify existing interests in the money paid into court rather than to create new ones. If the interest of a beneficiary in the moneys is vested and the beneficiary has a right to demand and receive payment of income, the fact that the interest and the right are disputed and await vindication by the order of the court will not make the interest contingent or negate the existence of the right. That being so, if a beneficiary is found by the court to have had a pre-existing interest in the income, the fact that the interest was not admitted or its extent was not ascertained at the time of payment in or until the making of the relevant order does not mean that the beneficiary was not presently entitled to it both at that time and during the period pending the court's determination.*

Whether the trustee's distribution resolutions are regarded as contingent and therefore not effective in making the beneficiary assessable, or whether the resolution is effective in providing the beneficiary with a vested and indefeasible interest, is illustrated by the facts and decision in **Lewski v FCT [2017] FCAFC 145** (**Lewski**). This case illustrates the practical implications of when a trustee attempts to achieve some flexibility in the trustee's resolutions by attempting to facilitate future contingencies which might result in a change in the income of the trust.

To some extent, the need to put in place resolutions to appropriate the trust's income by year end forces the trustee to speculate on all of the variables within the trust's income.

Lewski's case dealt with a number of issues, but for the purposes of the present discussion the relevant issues are relatively simple. The trustee prepared the following trust resolutions dealing with the 2006 trust income which attempted to separate the income distributions, if the Commissioner varied the net income of the trust.

The relevant resolutions were as follows:

Income of the trust fund:	*In accordance with the trust deed it was resolved to determine that for the year ended 30 June 2006 income of the trust includes all amounts (including capital gains) taken into account in calculating the net income of the trust.*
Distribution of trust income:	*It was resolved to pay, apply and set aside the income of the trust, as defined in the deed, for the year ending 30 June 2006 to or for the benefit of the beneficiaries in the manner and of the type as allowed under the deed such that the assessable income for taxation purposes of each beneficiary (and the class of assessable income from which their respective entitlements are appointed) is:*
Beneficiary	*Amount*
Roslyn Lewski	*100% of income*
Variation of income	*It was resolved that should the Commissioner of Taxation disallow any amount as a deduction or include any amount in the assessable income of the trust, and not distribute that amount so disallowed as a deduction, or so include in the assessable income in accordance with the above appropriation, such amount or amounts are to be deemed to be distributed on 30 June 2006 in the following manner:*
Beneficiary	*Amount*
Australian Commercial Underwriting Pty Ltd	*100% of income*

As at 30 June 2006, the financial statements for the ACE Trust showed a profit of $10,374,993. This amount was also shown as a distribution to beneficiaries.

The tax issue concerned the efficacy of the second resolution dealing with the distribution of any variation of the trust income.

The Court concluded in relation to the variation resolution that:

In relation to the Trust Resolutions Issue, we incline to the view that, in each case, the 'variation of income' resolution was authorised by the relevant trust deed. But, whether or not the 'variation of income' resolution was authorised by the relevant trust deed, the result is the same: the applicant was not "presently entitled" to a share of the income of the trust estate of the ACE Trust for the 2006 year or the Arjod Trust for the 2007 year.

It is the latter aspect of the decision that is the focus of the present discussion. To the extent relevant, the following citations from the Court's decision in Lewski encapsulates the essence of the factors to be considered:

> *In Walsh Bay, Beaumont and Sackville JJ explained (at 427-428):*
>
> > *A vested interest is one where the holder has an "immediate fixed right of present or future enjoyment": Glenn v Federal Commissioner of Land Tax (1915) 20 CLR 490 at 496, per Griffith CJ. In relation to land, an estate is vested in possession where there is a right of present enjoyment, as where A has a life estate or fee simple estate in the land. An estate is vested in interest where there is a present right of future enjoyment. Thus where T holds in trust for A for life and then in trust for B in fee simple, B's equitable fee simple estate is vested in interest during A's lifetime. The estate will vest in possession on A's death: Glenn v Commissioner, at 496; Dwight v FCT, at FCR 192.*
> >
> > *An estate is contingent if the title of the holder depends upon the occurrence of an event which may or may not take place: E H Barr, Cheshire's Modern Law of Real Property (11th ed, 1972), p 241. However, the mere fact that an estate will not fall into possession until the regular determination of a prior estate does not make the first estate contingent. As stated in C Fearne, Contingent Remainders and Executory Devises (10th ed, 1844), vol 1, p 216:*
> >
> > > *It is not the uncertainty of ever taking effect in possession that makes a remainder contingent; for to that, every remainder for life ... is and must be liable; as the remainder-man may die ... before the death of the tenant for life. The present capacity of taking effect in possession, if the possession were to become vacant, and not the certainty that the possession will become vacant before the estate limited in remainder determines, universally distinguishes a vested remainder from one that is contingent.*
>
> *For these reasons, it is said that before a beneficiary is entitled to a vested interest, two things must occur:*
>
> (a) *the beneficiary's identity must be established;*
>
> (b) *their right to the interest (as distinguished from their right to possession) must not depend upon the occurrence of some event.*

Having made the above observations, the Court then observed the significance of the trustee's resolutions and noted that:

> *In concluding, at [154]-[157] of the Reasons, that the applicant was presently entitled, the Tribunal treated the 'distribution of trust income' and the 'variation of income' resolutions as distinct and sequential. However, we do not consider it correct to treat the resolutions in this way. In the case of the ACPS resolutions, the two resolutions were made at the same time: they were set out in a single document signed by the sole director of the company. In the case of the Drewvale resolutions, the two resolutions were made at about the same time, at a meeting of the Board of Directors. In both cases, the resolutions were interdependent in*

that both resolutions dealt with the same subject matter – the distribution of the income of the trust for a particular year of income – with the latter resolution varying, in certain circumstances, the distribution made by the former resolution. In light of these matters, it is artificial to treat the two resolutions (namely, the 'distribution of trust income' resolution and the 'variation of income' resolution) as separate and sequential for the purposes of deciding whether the applicant was "presently entitled". Rather, the two resolutions should be read together for the purposes of deciding this question. There does not appear to be any issue between the parties that, if the two resolutions are read together, the distribution to the applicant was contingent: it depended on the occurrence of an event that may or may not take place (namely, the Commissioner disallowing a deduction or including an additional amount in assessable income). It follows that, assuming that each 'variation of income' resolution was authorised by the relevant trust deed, the applicant was not "presently entitled" to a share of the net income of the trust estate of the ACE Trust for the 2006 year or the Arjod Trust for the 2007 year.

Accordingly, if the two resolutions were to be read as one, the proposed distribution to Mr Lewski was contingent in that the resolution was dependent on the occurrence of the circumstances nominated in the second resolution. That being the circumstance, the taxpayer did not have a present entitlement to the trust income and, consequently, the trustee is assessed pursuant to section 99A ITAA 1936.

2.3 Default clauses

One of the important practical consequences of the Court's decision is reflected in the ATO's decision impact statement, which notes inter alia:

*Having determined the proper construction of the resolutions before it, the Court did not go on to identify how it considered the net income fell to be assessed. We think that where a resolution is a valid exercise of a trustee's power to deal with income under the deed but operates to create an entitlement for trust purposes that is not vested and indefeasible as at year end, there will be **no scope for a default beneficiary clause to operate**. The result would seem to be an assessment of the trustee under section 99A of the ITAA 1936*. (my emphasis)

In this regard, I note that clause 3.5 of the Acis deed provides:

Clause 3.5 Default distribution

(a) If:

(i) the Trustee has not exercised the discretion in clause 3.4(a); or

(ii) the whole or any part of the income of the Trust (however described or defined), has not been accumulated or distributed or made the subject of a determination under clause 3.4,

on or before the 30th day of June in any year or any later date permitted by the Act, the Commissioner of Taxation or by law for the distribution of taxable income of a trust, then the Trustee is deemed to have made a determination to distribute and Set Aside any Income remaining to, and is deemed to hold that Income on trust absolutely for, the Default Beneficiaries as at 12.00 midnight on that day and, if more than one, in equal shares.

(b) If and only if there are no Default Beneficiaries alive or in existence at 12.00 midnight on the 30th day of June in any year (or the later date referred to in clause

3.5(a)), the Trustee will be deemed to have accumulated the remaining Income referred to in clause 3.5(a)

Having regard to the Commissioner's observation of the Lewski decision, the Acis default clause is effective to deal with the situation where the trustee does not exercise their discretion to distribute the trust's income, with the consequence that the default income beneficiaries are assessable. This is to be contrasted with the situation that the trustee's income distribution resolution is defective in achieving the beneficiary having a present entitlement to the trust income.

Pursuant to the broad issue of what types of trustee's resolutions are effective in creating a present entitlement, is taxation determination **TD 2012/22** (subject to ATO's review as a consequence of Lewski's case.)

TD 2012/22 provides a range of resolution types that illustrate what is tax effective where there is a **variation** to the trust's income subsequent to the trustee's initial resolution. Some of the examples are largely irrelevant in the real world of practice; however, to the extent that there is relevance of other examples, they illustrate some cautionary practice:

Effective resolution types

(a) Example 3: entitlements expressed as a specific amount and balance

(b) Example 4: entitlement expressed as a proportion

(c) Example 5: income determined to be a particular amount - adjustment to net income with no impact on trust income (Note, the trustee did not define trust income and accordingly the trust income was the net income of the trust)

Ineffective resolution types

(d) Example 6: entitlements expressed as a percentage – ineffective further resolution (similar to Lewski's resolution which dealt with consequential income variation)

Streaming resolution

Example 11: specific entitlement to franked dividends

44. The trust deed for the Walnut Trust defines income to mean 'the amount worked out under section 95 of the tax law' unless otherwise determined by the trustee. The deed allows the trustee to maintain separate categories of income in the trust accounts and to appoint income of a particular type to designated beneficiaries.

45. During the 2010-2011 income year, the trustee received fully franked dividends of $70,000 and interest income of $50,000. The trustee calculated the trust's section 95 net income for the year as $150,000 (being $70,000 franked dividends plus $30,000 franking credits plus $50,000 interest income).

*46. By 30 June 2011 the trustee determined that the income of the trust estate was its net income as defined in section 95 of the ITAA 1936 (without stating what the dollar figure of that amount was), **less** any franking credits.*

47. Dividends and interest were recorded as separate categories of income in the trust accounts.

48. The trustee resolved that the income for the 30 June 2011 year be distributed to the following beneficiaries:

1Franked dividends

Pecan Pty Ltd	*100%*
Other income	
Pecan Pty Ltd	*$20,000*
Laura	*balance*

49. The Commissioner later determined that the interest income was understated by $10,000. This meant that the section 95 net income of the trust was $160,000 rather than $150,000 as the trustee had calculated. The trust's distributable income as at 30 June 2011 was therefore $130,000 (that is, $160,000 less $30,000). In accordance with the trustee's resolution, Laura (being the balance beneficiary) was entitled to an additional $10,000 interest income.

50. Disregarding the modifications to Division 6 of the ITAA 1936 effected by Division 6E, each of the beneficiaries would be assessed under section 97 of the ITAA 1936 on a share of the amended net income of the trust estate as follows:

> *Pecan Pty Ltd - $90,000 ($70,000 franked distributions plus $20,000 other income) / $130,000 x $160,000 = $110,769*
>
> *Laura - $40,000 / $130,000 x $160,000 = $49,231*

*51. **However**, because the net income includes a franked distribution, operation of section 97 of the ITAA 1936 is modified by Division 6E of the ITAA 1936. Broadly, this Division requires that the franked distribution and franking credit be disregarded in calculating the section 97 assessable amounts, with the following result:*

> *Pecan Pty Ltd - $20,000 (the other income to which it was entitled) / $60,000 ($130,000 income less $70,000 franked distributions) x $60,000 ($160,000 net income less both $70,000 franked distributions and $30,000 franking credits) = $20,000*
>
> *Laura - $40,000/$60,000 (as for Pecan Pty Ltd) x $60,000 (as for Pecan Pty Ltd) = $40,000*

52. As Pecan Pty Ltd is entitled to all of the $70,000 franked distribution received by the trustee, Subdivision 207-B of the ITAA 1997 will additionally operate to include in its assessable income for 2010-11:

> *its 100% share of the distribution ($70,000), and*
>
> *its 100% share of the franking credit on the franked distribution ($30,000).*

3. Streaming

3.1 Characterisation

Since the decisions in **Bamford** and **FCT v Greenhatch [2012] FCAFC 84**, the importance of being able to characterise the nature of the trust income and distribute various categories of income is now limited other than by the application of Division 6E ITAA 1936.

Division 6E applies in the following circumstances:

Section 102UW

Application of Division

This Division applies if:

(a) the net income of a trust estate exceeds nil; and

(b) any of the following things are taken into account in working out the net income of the trust estate:

(i) a capital gain (to the extent that an amount of the capital gain remained after applying steps 1 to 4 of the method statement in subsection 102-5(1) of the Income Tax Assessment Act 1997);

(ii) a franked distribution (to the extent that an amount of the franked distribution remained after reducing it by deductions that were directly relevant to it);

(iii) a franking credit.

The consequences of the above and the application of the Division, results in the preliminary trust income, net income and the present entitlement outcomes being revised to eliminate all of the above three inclusions (section 102UX).

The practical effect of the above is then to separately deal with the capital gains and the franked distributions within the relevant provisions (subdivision 115-C (Capital gains) and subdivision 207-B (franked distributions)).

Importantly, Division 6E and the consequential specific ITAA 1997 subdivisions apply irrespective of whether the trustee wishes to specifically stream the capital gain or the franked distribution.

Capital gain

Section 115-227 Share of a capital gain

*An entity that is a beneficiary or the trustee of a trust estate has a share of a * capital gain that is the sum of:*

*(a) the amount of the capital gain to which the entity is * specifically entitled; and*

*(b) if there is an amount of the capital gain to which no beneficiary of the trust estate is specifically entitled, and to which the trustee is not specifically entitled--that amount multiplied by the entity's * adjusted Division 6 percentage of the income of the trust estate for the relevant income year.*

Franked distribution

Subsection 207-55(4)

Section 207-55(4) For the purposes of column 3 of item 3 of the table in subsection (3), the amount is the sum of:

(a) so much of the amount worked out under column 2 of item 3 of the table in subsection (3) to which:

*(i) unless subparagraph (ii) applies--the focal entity is * specifically entitled; or*

(ii) *if the focal entity is the trustee and has the share amount because of the operation of section 98 of the Income Tax Assessment Act 1936 in respect of a beneficiary (see subparagraph 207-50(4)(b)(i))--the beneficiary is specifically entitled; and*

(b) *if there is an amount of the * franked distribution to which no beneficiary is specifically entitled--that amount multiplied by:*

(i) *unless subparagraph (ii) applies--the focal entity's * adjusted Division 6 percentage of the income of the trust for the relevant income year; or*

(ii) *if the focal entity is the trustee and has the share amount because of the operation of section 98 of the Income Tax Assessment Act 1936 in respect of a beneficiary (see subparagraph 207-50(4)(b)(i))--the beneficiary's adjusted Division 6 percentage of the income of the trust for the relevant income year.*

With regard to the ability to separately stream franking credits, the recent High Court decision in the case of **Thomas v FCT [2018] HCA 31 has reversed the earlier Full Federal Court decision [2017] FCAFC 57.** Whereas the taxpayer was successful with the Full Federal Court appeal, the High Court has rejected the basis of that Federal Court decision. Originally the Full Federal Court observed:

The application before his Honour [(ie Applegarth J)] required the Court to make sense of what may, perhaps not unfairly, be described as confused resolutions. The resolutions purported to do something and an ultimate intention could fairly be discerned however ineptly the two resolutions may have been drawn.

However the rights of the beneficiaries flowing as against the Commissioner from Div 207 of the 1997 Act depended wholly upon the effect of the rights created as between the trustee and the beneficiary by whatever the resolutions may have achieved.

The rights to be created by the trustee as against the Commissioner were a matter wholly within the control of the trustee and it was in the jurisdiction of the Supreme Court to make declarations concerning the proper construction of what the trustee had done pursuant to a domestic trust.

The Full Court continued:

The Commissioner was not obliged to participate in that proceeding, and may not be bound by the construction of Div 207, but the Commissioner is bound by a declaration concerning the effect of the resolutions if the declaration conclusively determines that a beneficiary has a share of the trust's net income for a year of income that is covered by s 97(1)(a) of the 1936 Act.

As a result, the Full Court found in favour of the taxpayer for the income years in which the original orders had been granted (2005-2008) and, "reluctantly", also for the 2009 resolutions, which had not been expressly considered by Applegarth J.

However, the High Court clearly indicated that the Full Federal Court was not restricted by the directions provided by Applegarth J. The High Court analysed the statutory provisions and implications of a franking credit.

Importantly, the High Court commented about the separate dealing with franking credits:

The Bifurcation Assumption involves the notion that franking credits are discrete items of income that may be dealt with or disposed of as if they were property under the general law.

That notion is contrary to the proper understanding of Pt 3.6. Franking credits are a creature of its provisions; their existence and significance depend on those provisions.

Part 3.6 of the 1997 Act creates an imputation system which sets out the effects of receiving a "franked distribution". The Part creates a distinction between franked distributions and franking credits, the latter being "on"[5] or attached to the franked distribution. Under the Part, when a corporate tax entity[6] distributes profits on which income tax has already been paid, the corporate tax entity may impute credits for that tax by "franking" the relevant distribution[7]

…

The system comprises four steps: first, where a franked distribution is made or flows indirectly to a trustee, the assessable income of the trust for that year includes the amount of franking credits on the distribution[13]; second, it is necessary to identify whether any of the franked distribution flows indirectly to a beneficiary of the trust[14]; third, if any of the franked distribution flows indirectly to a beneficiary of the trust, it is necessary to identify if the beneficiary has assessable income attributable to all or a part of the franked distribution[15]; and, fourth, if so, the beneficiary's assessable income will include a franking credit amount equal to its share of the franking credit on the franked distribution[16].

In respect of the fourth step, s 207-55 seeks to ensure that the amount of a franked distribution made to a trustee is allocated notionally amongst the beneficiaries who derive benefits from that distribution and that the allocation corresponds with the way in which those benefits were derived. Its sub-sections provide the mechanisms to achieve that objective. Section 207-55(2) provides that the amount notionally allocated, described as a share of the franked distribution, does not have to be received by the beneficiary. The table in s 207-55(3) provides the method for determining the share amount – relevantly, the beneficiary's share of the trust's net income for the relevant income year[17], usually calculated as a percentage of the trust's net income.

What is clear from this stepped approach (and particularly from the fourth stage) is that the statutory notional allocation of franking credits to beneficiaries follows the proportions which have been established with respect to their notional sharing in franked distributions at the earlier stages.

So long as a trust deed confers power on a trustee to apply classes of income of the trust estate to particular beneficiaries to the exclusion of other beneficiaries (or differentially among beneficiaries), Div 207 recognises that a trustee may stream the franked distribution (or any part of it) to one beneficiary and the other income to another beneficiary[18]. However, Div 207 does not treat franking credits as a separate source of income capable of being dealt with, and distributed, separately from the franked distribution to which they are attached. The scheme's objective in relation to trusts is to ensure that a beneficiary of a trust will have notionally attributed to it that proportion of the franked distributions received by the trustee that is referable to the amount of the net income distributed to the beneficiary while, at the same time, ensuring that the beneficiary obtains the benefit of the franking credits to the extent of those franked distributions. The franking credits are on[19], or attached to, the franked distribution.

As the taxpayers now accept, the Bifurcation Assumption – the proposition that franking credits could be distributed separately from, and in different proportions to, the income comprising the franked distributions – was wrong.

This decision reinforces the income status of franking credits – the franking credits are not and cannot form part of the income of the trust.

Separately in conclusion in both instances, that is, capital gains and franking credits, if there are no beneficiaries specifically entitled, the beneficiary will share in the respective type of trust distribution according to the adjusted Division 6 present entitlement percentage.

3.2 Attribution clauses

If the trust has derived a capital gain and/or a franked distribution during the year of income, and if the trustee wishes to stream those categories of income to specified beneficiaries, the trustee must carefully consider the drafting requirements to ensure that the trustees resolutions comply with the statutory streaming rules.

As a threshold issue, if the trustee does wish to specifically stream either capital gains or franked distributions, the trustee must first apply the relevant attribution clause to quarantine the relevant amount.

The Acis deed provides for attribution at clause 3.2, inter alia:

> *3.2 Classification of Income*
>
> *(a) The Trustee may classify any amount derived, received, or deemed to have been or treated as received, by the Trustee, as Income and may classify Income into one or more classes or partly as Income and partly as capital without limitation, as the Trustee decides, and may account separately for each class of Income or part of it.*
>
> *(b) Without limiting clause 3.2(a), the Trustee may identify and account separately for any amount derived, received or deemed to have been or treated as received by the Trustee or any part of the Income in any of the following (or any other) classes:*
>
> *(i) capital gains or profits including notional capital gains or profits;*
>
> *(ii) franked or unfranked distributions;*
>
> *(iii) distributable Income;*
>
> *(iv) Australian or foreign source Income;*
>
> *(v) Income to which a foreign tax or other credit attaches;*
>
> *(vi) Income from primary production;*
>
> *(vii) exempt Income or Income which is subject to differing rates of tax or tax treatment;*
>
> *(viii) interest;*
>
> *(ix) royalties;*
>
> *(x) rents;*
>
> *(xi) notional amounts received or treated as received by the Trustee; or*
>
> *(xii) Income which has or gives rise to any other separately identifiable taxation consequence or benefit.*

3.3 Streaming of capital gain

The taxation treatment of capital gains of a trust is, as stated above, covered by subdivision 115-C. More specifically, if the trustee wishes to stream a capital gain, the trustee must carefully consider the elements of section 115-228:

> *Section 115-228(1) A beneficiary of a trust estate is specifically entitled to an amount of a * capital gain made by the trust estate in an income year equal to the amount calculated under the following formula:*
>
> $$\text{*Capital gain} \quad x \quad \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$
>
> *where:*
>
> *"net financial benefit" means an amount equal to the * financial benefit that is referable to the * capital gain (after any application by the trustee of losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)).*
>
> *"share of net financial benefit" means an amount equal to the * financial benefit that, in accordance with the terms of the trust:*
>
> *(a) the beneficiary has received, or can be reasonably expected to receive; and*
>
> *(b) is referable to the * capital gain (after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)); and*
>
> *(c) is recorded, in its character as referable to the capital gain, in the accounts or records of the trust no later than 2 months after the end of the income year.*

In relation to the above section, the essential elements needed to be considered are:

(a) What does the term "capital gain" as used in the formula mean?

(b) What capital gain is being streamed?

(c) How is the net financial benefit of the capital gain determined?

(d) What is the trustee's process to deliver a beneficiary of share of the financial benefit of the capital gain?

Capital gain

The term capital gain is a defined term and takes its ultimate meaning from the relevant CGT event. For example, the capital gain of a CGT event A1 is the described as follows:

> *Section 104-10(4)*
>
> *You make a capital gain if the * capital proceeds from the disposal are more than the asset's * cost base. You make a capital loss if those capital proceeds are less than the asset's * reduced cost base.*

Importantly, the gain is the gross capital gain and not the post Division 115 discounted gain and relevantly it is the gross capital gain that must be distributed.

What capital gain?

Section 115-228 allows for each capital gain to be separately streamed. This might be relevant where there are:

(a) Non-discounted capital gains;

(b) Discounted capital gains;

(c) Capital losses.

To deal appropriately with these options, the trustee must, by resolution, determine to:

(a) Activate the attribution clause to differentiate the characterisation of the separate capital gains – discount and non-discounted;

(b) Apply any capital losses against the different capital gains.

Referring to the Acis deed:

(a) Clause 4.1 allows the trustee to classify each and every capital gain separately; and

(b) Clause 5.3 allows the trustee to resolve to set-off against each capital gains any capital loss of the trust.

Net financial benefit

In accordance with the definition of "net financial benefit" of a capital gain, the term means:

> *...the *financial benefit that is referable to the *capital gain (after any application by the trustee of losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)).*

That is, the net financial benefit is:

(a) The gross capital gain; **less**

(b) The application of capital losses (as resolved by the trustee).

Share of the financial benefit

The critical issue is that the gross capital gain must be distributed to the relevant beneficiary.

This requirement needs the trustee to carefully consider the manner of how the trustee facilitates this factor. This raises the following questions:

(a) Does the income of the trust include some proportion of the capital gain?

(b) Is the proportion of the trust income relevant to the capital gain being distributed as a distribution of the trust income (clause 3.4) and the balance of the capital gain a distribution of capital (clause 4.2)?

(c) Is it appropriate that the trustee exercise the prerogative of the trust deed to determine that the income of the trust to exclude or include a capital gain and to distribute the gross capital gain either as entirely an income distribution or as a capital distribution?

4. Division 152

Division 152 has some particular issues for a discretionary trust that are reliant on the various income/capital resolutions initiated by the trustee.

(a) Determining the MNAV for a discretionary trust requires a determination of which entities are:

(i) Connected entities;

(ii) Affiliates.

(b) How to calculate the "net asset" position if the trust has UPEs owing to beneficiaries?

(c) How do you ascertain whether an individual is a CGT concession stakeholder of the trust?

(d) How does the trustee resolve to make payments to the CGT concession stakeholders for the purposes of subdivision 152-B and subdivision 152-D?

4.1 MNAV of trust taxpayer

Unless the trust is a CGT small business entity (section 152-10(1AA)), that is, the trust can satisfy the following test that the trust:

(a) Carries on a business; and

(b) Has an aggregated turnover of less than $2 million; then

the principal eligibility test (section 152-10(1)(c)(ii)) for a trust will be the MNAV test (refer to section 152-15 &152-20).

Putting aside the vexed question of whether the trust carries on a business (particularly having regard to TR 2017/D7 which deals with the issue of whether a company carries on business), the subsidiary question is which entity, if any, is connected to the trust to calculate the aggregated turnover of the trust.

This latter question focuses attention on who is connected to the trust. This question requires attention to be given to the connected entity tests provided by section 328-125. There are a number of matters to consider with regard to this provision:

(a) The same entity controls other entities, which makes the controlled entities connected (section 328-125(1);

(b) An entity controls the decision making of the trustee of the trust (section 328-125(3); and

(c) An entity, or the entity and any affiliates, has in any of the 4 years prior to the year of the CGT event, received or had applied for its benefit, any of the income or capital of the trust (section 328-125(4)).

There are a couple of aspects of the above connected entity tests that focus attention on the implications of a trustee's resolution:

(a) The trustee's resolution in the relevant years can result in another entity being connected which could have implications for the turnover test; and

(b) The distribution test of subsection 328-125(4) requires an identification of what constitutes "income" and "capital".

The terms "income" and "capital" are defined by trust law concepts – refer back to the earlier comments in relation to income of the trust and Bamford. Accordingly, how the trust deed (or the trustee) defines the income of the trust is the determining factor, not the tax concepts of income or capital.

As a separate note, the calculation of the net assets of the trust (section 152-20) will need to have regard to taxation ruling TR 2015/4.

4.2 CGT concession stakeholder

An individual will be a CGT concession stakeholder of a trust (section 152-60), if the individual is either:

(a) A significant individual; or

(b) A spouse of a significant individual where the spouse has a small business participation percentage of greater than zero.

The test to determine whether an individual is a significant individual is provided by section 152-55. That is, the individual has a small business participation percentage (direct or indirect) of at least 20%. More specifically, the statute (section 152-70 item 3) outlines the relevant test:

> *This percentage:*
>
> *(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.*

Importantly, the small business participation percentage is determined in the year of the CGT event, not like the connected entity test which is based on the historical distributions of the trust income and/or capital of the trust for the 4 years preceding the CGT event.

The relevance of the determination of whether an individual is a CGT concession stakeholder is highlighted by the following situations:

(a) Satisfying the additional basic condition test if the CGT asset subject to the CGT event is a share in a company (section 152-10(2)(b)):

> *Section 152-10(2) If the * CGT asset is a * share in a company or an interest in a trust (the object company or trust), one of these additional basic conditions must be satisfied just before the * CGT event:*
>
> *(a) you are a * CGT concession stakeholder in the object company or trust; or*
>
> *(b) CGT concession stakeholders in the object company or trust together have a * small business participation percentage in you of at least 90%.*

The latter paragraph focuses the trustee's attention to the income and capital distributions the trustee makes for the year of the CGT Event.

(b) Satisfying the subdivision 152-B concession, which includes as a critical condition that the relevant CGT asset is disposed as a consequence of the retirement of a significant

individual (section 152-110) and also that the distribution of the "exempt amount" is made to the trust's CGT concession stakeholder (section 152-125).

(c) Satisfying the subdivision 152-D retirement concession, which requires the trust making a payment to or for the benefit of a CGT concession stakeholder.

Accordingly, in all of the above situations, the application of the concession is dependent on the trustee's distributions of the income or capital of the trust.

As a separate observation, the payment to a CGT concession stakeholder is invariably a payment to a beneficiary of the trust, but note that the payment pursuant to subdivision 152-B or subdivision 152-D is made for the purpose of reducing the capital gain. The trustee should separately note that payment as a reduction of what would otherwise be a capital gain of the trust.

Trust updates

What are the implications of the Government's 2018 budget announcement concerning the proposed Division 7A treatment of UPEs?

TR 2010/3 introduced UPEs owing to a company to the world of Division 7A, on the basis that by not requesting the payment of the UPE, the company was providing the trust with some form of financial accommodation and accordingly is a loan for the purposes of section 109D ITAA 1936.

To appease the taxpayer's angst as a consequence of this change in interpretation, the ATO provided an administrative method to reduce the impact of Division 7A applying to the UPE (PS LA 2010/4).

Unfortunately, as with many things associated with SME taxation, the Government is quick to notify of proposed changes, but delinquent in providing details.

It is proposed that from 1 July 2019, measures will be introduced to ensure that an UPE will come within the scope of Division 7A.

Presumably, these measures mean that UPEs will either be required to be repaid to the private company over time as a complying loan or will be subject to tax as a dividend.

At this moment, there is no indication as to whether this change will apply only to future UPEs, or will also transition to existing arrangements in place (and in particular, pre-2009 UPEs). Whatever the eventual change, unless there is a fundamental change to adopt the original Board of Taxation's recommendation, there continues to be increasing reason to use companies as the primary trading entity vis a vis a trust.