

## DISCRETIONARY (FAMILY) TRUSTS: DISTRIBUTIONS OF INCOME/CAPITAL

### *Distributions by Discretionary Trusts*

At this time of the financial year, most tax professionals are overwhelmed with year-end tax planning and compliance issues. At some stage before 31 August, advisers of clients with discretionary trust arrangements must also turn their minds to the complicated matter of trust distributions. This area is now full of traps for the unwary. Tread carefully or the distribution could fail. If this occurs, depending on the terms of the trust deed, the default beneficiaries may be fully assessable for the amount of the distribution or the trustee may suffer the top marginal tax rate on income to which no person was presently entitled.

When you consider the exercise of a trustee's discretion to appoint income and advise your clients in relation to their trust distributions this year, you may wish to take note of the following (or ignore them at your peril):

1. **Read the Trust Deed Carefully.** The terms of the trust and the purpose for which it was established are the guiding principles behind every exercise of a trustee's discretion. You might think that this tip goes without saying; however, it is surprising how often it is apparent to us that advisers have not considered the relevant terms of the trust deed before implementing a trust transaction or effecting a trust payment. If a trustee acts *ultra vires* (beyond its powers), the results are problematic and in many cases disastrous. When in doubt, seek legal advice on the terms of the trust deed. So important is this tip, that many of the other tips referred to below are simply particular applications of this one.
2. **Double Check the Appointee.** Double check that the proposed appointee is a member of the class of beneficiaries properly entitled to a trust distribution. Otherwise, the purported distribution is void. In the recent *Ramsden* case, a purported beneficiary of the trust named in the distribution minutes was not in fact a proper member of the class of potential beneficiaries. The result was that the distribution allocated to that purported beneficiary was actually income to which the default beneficiaries were presently entitled. And another thing - ensure that the appointee (e.g. company or trust) is in existence at the time of appointment. This was an issue in the *BRK* case, with the result that the distribution failed and the trustee was assessed to tax on that failed distribution at the top marginal rate.
3. **Follow the Formal Legal Requirements.** The exercise of the trustee's discretion must follow the formal legal requirements set out in the trust deed. If the trust has a corporate trustee, the trustee's constitution and relevant company law must also be considered and complied with. A corporate trustee's resolutions must comply strictly with the company's constitution and company law. Do not dispense with formal meeting requirements (such as quorums) – as occurred in the *Faucilles* case to the detriment of all concerned. If the nomination requirements in the trust deed require a nomination by deed or in writing, do not dispense with these formal procedures.
4. **Streaming Net Income.** This can be a useful tax mitigation technique; however, from a trust law and ATO perspective, the trustee must be specifically empowered by the trust deed to attribute income, the accounting records of the trust must separate the trust income and the administration and management of the trust must be consistent with this attribution and allocation. It is also critical that the distribution resolution be crafted consistently with such attribution and allocation.
5. **Streaming Dividends.** Where the trust is in receipt of franked dividends, think carefully about the operation of the holding period rules applicable to claiming franking credits. Although these rules may be short-circuited by electing to be treated as a family trust, this decision is irrevocable and accordingly has long term implications – therefore it should not be taken lightly.
6. **Preparing Distribution Minutes.** The days of 'filling in the blanks' in pro-forma or generic minutes, without particular regard to the trust deed or the circumstances, are over. Each distribution minute should be carefully considered and prepared taking into account, among other things, the provisions of the trust deed, recent case-law and ATO practice.
7. **Unpaid Trust Distributions.** Bear in mind that unpaid trust distributions are not, as such, a loan and should not necessarily be debited to a loan account. In each case you should consider the precise and correct nature of the undistributed beneficiary entitlement and the best way to address it.
8. **Division 7A.** *Subdivision EA of Division 7A* continues to present many problems to our SME clients. Broadly speaking, these provisions require consideration whenever a corporate beneficiary of a trust has an unpaid present entitlement from the trust and, in economic terms, a transfer of value (i.e. a payment, loan or debt forgiveness) is made by the trust to a shareholder (or shareholder's associate) of the company. In such circumstances, these provisions may treat such transfer of value for tax purposes as an unfranked dividend of the company in the hands of payee. Every payment and loan by a trust to a shareholder (or its associate) of a corporate beneficiary needs to be critically reviewed for compliance with Division 7A. Division 7A is not a discretionary provision and cannot be ignored – take action and seek advice to avoid or mitigate the application of Division 7A *before* that ATO audit occurs and *before* your client takes you to task for this oversight.

Liability limited by a scheme approved under Professional Standards Legislation.

9. **Sham Transactions.** Remember that the courts have shown themselves very willing to consider as 'shams' various actions purporting to be valid distributions of trust income. These include, for example, distributions to beneficiaries that are unaware of their entitlement, distributions made invalidly and journalised entries where there is no intention at all to pay out such entry in cash.
10. **Family Trust Elections.** It is critical that distributions made by a trust that has made a family trust election are allocated to the family group of the test individual (or interposed entities) in accordance with the relevant family trust election. Otherwise the trust may lose its carried forward losses, its access to dividend franking benefits for beneficiaries and suffer family trust distribution tax at 46.5%.
11. **Borrowings for Trust Distributions.** Are you contemplating that a trustee borrows funds to pay unpaid present entitlements to beneficiaries? If so, you should consider carefully the principles in *Draft Ruling TR 2005/D4* which sets out the Commissioner's views on the circumstances in which interest payable on such borrowings will be deductible.
12. **Superannuation 'Special Income'.** The use of discretionary trusts in connection with superannuation funds requires special care. Remember that any distribution to a superannuation fund by a trust that is not a unit trust (e.g. a discretionary trust) is *special income* taxed in the fund at 46.5%.
13. **Amending the Trust Deed.** If you think it necessary to revisit and amend the terms of the trust deed (e.g. to include a new beneficiary), seek legal advice. Great care must be taken to avoid a resettlement of the trust having regard to, among other things, the *Commissioner's Statement of Principles 2001*. A resettlement will, among other things, trigger a disposal of the assets of the trust for capital gains tax purposes and a conveyance for stamp duty purposes. It is critical that considered expert legal advice is taken in connection with the amendment of any trust deed.

## About Us

**Baggiolegal** is a boutique law firm, specialising in commercial, taxation and private client law. **We understand** our client's objectives and provide clear and independent advice. Service is paramount to us. **We deliver** technically sound, timely and commercially oriented solutions. **We know** and understand the South Australian landscape, but our international perspective is unique in Adelaide. Our people have excelled in the legal profession in private practice and industry all over the world. **We apply** international best practice to our local client's needs. **We work** with our clients. **We listen** to our clients. We are approachable, accessible and personable.

*These materials are for general information purposes only and do not constitute legal advice. Before acting on any of our views expressed in this publication, careful consideration of the case specific facts should be undertaken by a qualified lawyer.*