

Tax Update

Tax liability of discretionary trust beneficiaries

The decision of the Full Federal Court in Bamford v Commissioner of Taxation [2009] FCAFC 66, handed down on 3 June 2009, has important implications in relation to the tax liability of the recipients of beneficial entitlements from discretionary trusts. In this matter the Court was asked to consider two issues which are critical to the operation of trust and tax law in Australia. The dispute arose as a result of the disallowance of substantial tax deductions to a trust and the inclusion of taxable capital gains in an allocation to a beneficiary.

Quantum vs proportionate approach

The first issue was whether a beneficiary who is allocated a specific amount (rather than a proportion of the trust income) under a trust resolution is taxable only on that amount (the "quantum view") or on their proportion of the net income of the trust estate for tax purposes (the "proportionate view"). Emmett J, with whom Stone and Perram JJ agreed, found that the proportionate approach was the correct one.

The Court found that the language of the relevant legislation must mean that a proportionate approach was intended. It was the taxpayers that argued against the proportionate approach on the particular facts, but their submissions were rejected. The Court applied the earlier Federal Court decision in *Zeta-Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70.

Net income of the trust estate

The second issue was whether a determination by a trustee (in accordance with the deed) that the "income of the trust estate" includes amounts which are not ordinary income, such as capital gains, is effective.

This issue had previously been considered by the Court in *Cajkusic v Commissioner of Taxation* [2006] FCAFC 164, where it was found that "income of the trust estate" was indeed a separate concept from "income according to ordinary concepts" and accordingly it was open to a trustee to



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re-classify receipts in such a manner. In *Bamford*, the Commissioner invited the Court not to follow *Cajkusic* (and argued against his own statements in PS LA 2005/1). However, the Court effectively affirmed that decision and the reasoning behind it.

Implications of the case

Taxpayers and tax advisers will generally welcome these decisions that should bring the debate on these issues to a close.

The practical ramifications of *Bamford* are that the widespread practices of re-classifying receipts for trust income purposes and apportioning tax net income in accordance with the proportionate view have been validated. Of course, this decision does not empower a trustee to do anything which the trust deed does not permit. Indeed, the decision demonstrates that close scrutiny of the deed and resolutions are vital in determining the outcome in each case.

Issues with trust income

The *Bamford* decision highlights how important it is to correctly deal with the income of a trust estate. If there is no definition of "income" in a deed, nor any power for a trustee to determine what constitutes "income", then any distributions of income will only be of income according to ordinary concepts. This can have unexpected results under the proportionate approach, such as the tax payable on capital gains being borne by the income beneficiaries while capital gains remain undistributed or are distributed to others.

Getting the intended result

There are some simple strategies that can be taken so that a trust distribution may achieve the desired outcome and comply with the principles in *Bamford*.

First, the terms of the deed should be reviewed to discern the provisions dealing with the scope and allocation of entitlements to net income and capital, what discretionary powers the trustee has in relation to such entitlements and what the trustee is required to do in exercising those powers. Secondly, there are the decisions to be made in accordance with the deed and documented in the form of resolutions. In our experience a substantial proportion of trust resolutions are made without taking these preliminary steps.

In *Bamford*, the way the trustee made its determinations and resolution meant that when there was an amendment in the net income for tax purposes on disallowance of certain deductions, the entitlements of the beneficiaries did not change.

We have seen many resolutions that are non-compliant with the deed, for instance being made outside the time permitted or being made in favour of persons who are not within the pool of eligible beneficiaries. Such resolutions can obviously lead to problems and are liable to be considered void by the ATO if investigated, which may result in a trustee being taxed at the maximum rate on accumulated income.

No definition of net income

A deed which does not allow a trustee to define net income can restrict flexibility and make it difficult to get distributions right. An amendment of the deed may be preferred which provides a suitable default definition of income, allows the trustee to include or exclude specific amounts where necessary and empowers the trustee to classify and stream particular receipts to particular beneficiaries. Generally, such an amendment will not constitute a re-settlement of the trust.

Where there is no definition of net income and no scope for the trustee to define net income

for trust purposes, the trust income is determined under ordinary concepts and will not include items such as capital gains. The Commissioner in PS LA 2005/1 states that a "capital beneficiary" approach will be acceptable whereby the capital beneficiaries of a trust estate can accept the tax liability on their distributions of a capital gain (under the capital distribution power) if a suitable agreement is put in place (this must be done for each year). This approach is not preferred as it is of dubious legal basis and the Commissioner is not bound to follow his own guidelines in this regard.

Trust issues generally

These and many other issues commonly arise from the use of trusts to create or distribute wealth. Our tax team has substantial experience with such issues, including:

- Updating of trust deeds
- Capital beneficiary agreements
- Review of trust deed provisions and resolutions
- Trust losses rules
- Family Trust Elections
- The recording and treatment of Unpaid Beneficial Entitlements
- Division 7A issues
- Resettlement issues
- Succession issues
- Structuring issues generally

We would be happy to advise you on these, or any other, trust related issues. Please contact Ross Higgins, rhiggins@rigbycooke.com.au or Arthur Athanasiou, aga@rigbycooke.com.au

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