



Review of Trust Deeds - Post Bamford

Issues on review of trust deeds

1. As a result of the decision in *Bamford*, Cooper Grace Ward recommend that trust deeds should:
 - a. define the trust income as being equal section 95 net income **excluding "notional amounts"**; but
 - b. also provide that the trustee has a discretion to adopt alternative concepts of income in any year; and
 - c. allow the trustee a discretion to make distributions from gross income before deducting expenses.
2. If a trust deed does not define income as being equal to section 95 net income but does allow the trustee a discretion to treat income amounts as if they were capital and vice versa, this will allow the trustee to distribute capital gains as part of trust income – **provided there is adequate evidence the trustee actually exercised this discretion.**

The trust deed in *Bamford* fell into this category and, in the AAT hearing, the AAT agreed with the ATO that, even if the clause allowing the trustee to include capital gains in income had been effective, there was not sufficient evidence that the trustee had actually exercised the discretion.

The ATO did not appear to pursue this point in the appeals, but may well raise this issue in a client audit.

Because of this risk, Cooper Grace Ward consider it is better to define the income as being equal to section 95 net income. If the trustee has a discretion to adopt different concepts of income they can always exercise this discretion if applying the section 95 definition is not appropriate in any year.

3. Cooper Grace Ward exclude "notional amounts" from the definition of income. The main category of notional amount is a franking credit attaching to a franked dividend.

There are several reasons for this:

- a. Firstly, if the notional amounts are included in the definition of net income, the trustee ends up having to make a distribution of an amount that does not exist which creates technical problems in determining the amount of beneficiary balances.
- b. Also, if the notional amount does not actually exist, a beneficiary cannot be "presently entitled" to that amount.

This may result in the trustee being assessed on part of the net income under section 99A.

- c. In the Decision Impact Statement issued following the *Bamford* decision, the ATO has specifically raised the issue of the effectiveness of definitions that equate trust income with section 95 net income where the section 95 net income includes "notional" amounts such as franking credits.

These comments and opinions are of a general nature and are based on Cooper Grace Ward's interpretation of the law as at the date the document was prepared. The position may alter if the law changes as a result of legislation, new rulings or cases. Clients should obtain specific advice on the implications of their trust deed or any amendments to the deed and also in relation to trust distribution strategies and procedures.





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Retaining the benefit of franking credits where there is no net income

4. A beneficiary is only entitled to claim the benefit of imputation credits attaching to a franked dividend to the extent the beneficiary is presently entitled to a share of the trust's income under section 97 (section 207 50).

The concept of "present entitlement" is not defined in the Tax Acts. However it has been considered by the courts.

5. The key issue that emerges from these cases is that, in order for a beneficiary to be presently entitled to a share of the income of the trust estate, that beneficiary must have an indefeasible and absolutely vested interest in the income **and must be able to demand immediate payment of their share of the income from the trustee.**
6. The difficulty where the trust estate has positive "net income" under section 95 only because the net income includes imputation credits, is that, while it may be possible to calculate an amount of net income, this is a notional amount which cannot actually be distributed to a beneficiary and therefore they cannot be presently entitled to it.

That is, there is no "distributable income".
7. The view of the ATO is that, if there is no income actually available for distribution in a year then there is no amount to which a beneficiary can be presently entitled under section 97, even though the trust itself may have a positive "net income" under section 95 because of the requirement to gross up the imputation credit (*Taxation Ruling TR 92/13* at paragraph 17).
8. One option that may allow the trustee to pass on imputation credits even where the trust has no distributable net income is to include a provision in the trust deed allowing the trustee to make distributions out of gross income.

Section 97 only requires that the beneficiary is entitled to a share of the "income" and not the net income of the trust estate. This distinction was pointed out by Kitto J in *Union Fidelity Trustee Co of Australia Ltd v FCT*.

Therefore, if the trustee has the power to make distributions out of the gross income (before calculating the distributable net income) it is at least arguable that the beneficiaries are entitled to a share of the trust "income" under section 97 and would in turn be required to include the same proportion of section 95 "net income" (ie. the imputation amount) in their assessable income.

Cooper Grace Ward therefore recommend that trust deeds should allow the trustee a discretion to apply some other concept of income in any particular year.

9. The ATO acknowledge that, as a result of the High Court decision in *Bamford*, the trust deed can permit the trustee to determine whether "an outgoing is properly chargeable against the income of a period.." which provides further support for this strategy.

Income Attribution Clauses

10. The trust deed should also have an adequate "attribution" clause allowing the trustee to differentiate between different categories of income and to distribute these different categories to beneficiaries in disproportionate shares.

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11. In the Decision Impact Statement for *Bamford*, the ATO have questioned the effect of income attribution in clauses as they argue the effect of the decision in *Bamford* and in the earlier case of *Custodian Nominees* is that income received by a trustee does not retain its character when distributed to beneficiaries.

Even if the ATO view is correct, there is a strong argument that discount capital gains and franked dividends can still be streamed to beneficiaries as the streaming of these classes of income is effectively allowed under specific provisions in the Tax Act (sections 115-215 and sections 207-50 and 207-55).

12. However, to take advantage of these statutory concessions, the deed will need to include an adequate attribution provisions.

Timing of distribution minutes

13. The trust deed should not require the trustee to distribute income by 30 June in any year given the strict approach the ATO has indicated it will take on this issue.

The Cooper Grace Ward deed simply provides that the trustee can in respect of a year make a distribution without limiting the timeframe within this must be done.

14. If the trust deed requires the distribution to be made by 30 June this will often be a practical problem.

Cooper Grace Ward are currently acting for several clients who have pending AAT appeals involving trust distribution issues where the ATO has flagged that it does not necessarily accept that the trust minutes are valid - because of this 30 June issue.

15. The preferable approach is to remove provisions from trust deeds that require the trustee to make distribution resolutions by 30 June.

If there is no 30 June requirement, the ATO has accepted the trustee then has a reasonable time to make the distribution (IT 328 and 329). However, in those rulings the ATO indicate that they will only allow two months in which to make the resolutions.

The Federal Court confirmed that a trustee has a reasonable time in which to exercise the discretion to distribute trust income – at least where there was no requirement in the deed to do so by 30 June (*BRK (Bris) Pty Ltd v Commissioner of Taxation* [2001] FCA 164 at paragraph 34).

Although the ATO indicated in IT 328 and 329 that they consider two months is a reasonable time to make the distribution, the court in *BRK* specifically said that the trustee had **"a reasonable time after the income had been determined for the financial year or is capable of being ascertained ..."** (paragraph 33)

Other Trust Review Issues

16. It is important to carefully check the variation clause to ensure any changes we are making are permitted and also to ensure that the power to make future changes is not unduly limited.

The problems with some variation clauses are illustrated by the case of *Jenkins v. Ellett* ([2007] QSC 145).

Essentially the variation clause must allow the trustee (or whoever else has the power) to vary any of the provisions in the trust deed.

The problem in *Jenkins v. Ellett* was that the court construed the variation clause as limiting the trustees to a power to vary the "trusts" declared by the document and not the administrative provisions or schedule items.

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