[Insert DD Month YYYY]

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[Insert Client Name]

[Insert Client Position]

[Insert Company Name]

[Insert Company Address]

[Suburb State Post Code]

Dear [Insert Client Name]

**Re: Issues for trustees in exercising a discretion to distribute trust income/gains at year-end**

Trustees making beneficiaries of a discretionary trust presently entitled to a share of trust income at year-end must consider a range of important rulings, cases and legislative developments before exercising a discretion allocating trust income (and therefore the net income of a trust) amongst beneficiaries. We have highlighted some of the more significant factors that a trustee should take into account before year-end in determining how trust income and capital gains should be distributed.

**Executive Summary**

We provide an explanation below of each of the following factors which should be considered by a trustee in exercising their discretion to distribute trust income:

1. The streaming rules, under which a trustee of a discretionary trust can make beneficiaries specifically entitled to a capital gain and/or franked dividend in certain circumstances.
2. The application of Draft Taxation Ruling TR 2012/D1, which explains the ATO’s view on the meaning of ‘trust income’ after taking into account the High Court’s landmark decision in *Commissioner of Taxation v* Bamford (2010) HCA 10 (**Bamford**)*.*
3. Section 100A of the *Income Tax Assessment Act 1936 (***ITAA 1936**) and the Commissioner’s views in Taxation Ruling 2022/4 and Practical Compliance Guideline 2022/21.
4. The general anti avoidance rules in Part IVA of the ITAA 1936.
5. The steps that should be undertaken in documenting an effective trustee resolution allocating trust income and/or capital gains amongst beneficiaries.
6. Key disclosures required to be made in the trust income tax return form.

**Background – Bamford and the meaning of income**

Before discussing each of the above factors, it is helpful to briefly outline the relevant legislative provisions concerning the taxation of trusts.

Pursuant to Division 6 of the ITAA 1836, beneficiaries of a trust are ordinarily liable for tax on the trust’s net income (i.e. taxable income) rather than the trustee[[1]](#footnote-2).

Specifically, a beneficiary that is presently entitled to a share of the trust’s income will be subject to tax on that same share (i.e. proportion) of the trust’s net income. In *Bamford*, the High Court held that a trust’s ‘income’ was its income according to trust law[[2]](#footnote-3).

Under these trust law principles, any definition of ‘income’ contained in the Trust Deed will be relevant when determining the trust’s income.

* **Streaming rules**

In response to Bamford, the ATO took the view that the proportionate approach adopted by the High Court would not permit the streaming of certain classes of income[[3]](#footnote-4). This view prompted legislative amendments which were designed to allow the streaming of capital gains and franked dividends subject to certain conditions being satisfied[[4]](#footnote-5).

Key issues to be considered in relation to the streaming rules are explained below.

1. *Trust Deed requirements*

There is doubt as to whether the streaming rules give a trustee power to stream capital gains or franked dividends, where no such power exists in the Trust Deed. Consequently, trustees who wish to stream such amounts should review the Trust Deed to ensure that streaming is permitted.

Care should be taken to ensure that any amendments to a Trust Deed to insert a clause allowing a trustee a discretion to stream capital gains and franked dividends is made under a valid power of amendment and does not give rise to a resettlement for stamp duty or tax purposes. Taxation Determination TD 2012/21 addresses this issue from a tax perspective.

1. *Specific entitlement to franked dividends or capital gains*

To effectively stream a capital gain or franked dividend the trustee must make a beneficiary ‘specifically entitled’ to a share of an amount equal to the net financial benefit referable to that capital gain or franked dividend.

Under sections 115-228 and 207-58 of the *Income Tax Assessment Act* 1997 (***ITAA 1997***), a beneficiary will be specifically entitled to an amount equal to a share of the net financial benefit where:

* the beneficiary has received, or can reasonably expect to receive, such an amount
* the amount is referrable to the capital gain or franked dividend (after respectively applying any trust capital losses or directly relevant expenses. such as interest)
* the amount is recorded, as referrable to the capital gain or franked dividend in the accounts or records of the trust no later than:
	+ two months after the end of the income year for capital gains or
	+ the end of the income year for franked dividends.
1. *Streamed capital gains and franked dividends excluded from trust income*

If the trustee makes a beneficiary specifically entitled to a capital gain or franked dividend that amount will be excluded from the income of the trust estate[[5]](#footnote-6) and the trust’s net income[[6]](#footnote-7) in working out the remaining beneficiaries’ share of the net income[[7]](#footnote-8). In other words, the trust is deemed to not have derived capital gains or franked dividend income which has been streamed for the purpose of working out a beneficiary’s present entitlement to a share of trust income and net income under the normal tax rules for trusts.

1. *Streamed capital gains and franked dividends are taxed on a quantum basis*

The capital gain or franked dividend will then be assessable to that specific beneficiary effectively on a quantum basis being the amounts received.

* **Relevant anti-avoidance measures**

It is important that various anti-avoidance rules be considered in relation to distributions of trust income and there have been some important recent developments in this regard in relation to section 100A and Part IVA of ITAA 1936.

Section 100A is an anti-avoidance provision that has the potential of imposing a penal tax outcome where one person (beneficiary) is made presently entitled to trust income, but another person effectively receives the benefit of the income. For this provision to apply, there needs to be an arrangement or understanding that this benefit will be provided to a person other than the beneficiary at the time that the entitlement to income arises and a tax benefit needs to be identifiable from the arrangement. Arrangements that are ordinary family or commercial dealings are excluded from the application of section 100A. Importantly, where section 100A applies, the beneficiary’s entitlement to income is deemed not to have arisen, with the result that the trustee is assessed on the income at the top marginal tax rate of 47%.

The Commissioner has issued the following tax rulings / compliance guidelines in relation to section 100A:

* Taxation Ruling 2022/4 – Income tax: section 100A reimbursement agreements
* Taxpayer Alert TA 2022/1 – Parents benefitting from the trust entitlements of their children over 18 years of age
* Practical Compliance Guideline 2022/2 – Section 100A reimbursement agreements – ATO compliance approach

Notably, and unlike many other provisions in tax legislation (including the anti-avoidance rules in Part IVA), section 100A has an unlimited amendment period.

Part IVA is the general anti-avoidance provision of Australian income tax law. Part IVA essentially empowers the Commissioner to strike down a scheme that that has been entered into with the dominant purpose of obtaining a tax benefit.

A Full Federal Court decision handed down in January 2023 (*Commissioner of Taxation v Guardian AIT Pty Ltd ATF Australian Investment Trust* [2023] FCAFC 3) considered the application of both Part IVA and section 100A to certain arrangements involving discretionary trust distributions. In brief, the Court held:

* in favour of the taxpayer that section 100A did not apply to the relevant income distributions, on the basis that the arrangement under which another person may benefit from the income distribution (rather than the beneficiary) did not exist at the time that the distribution of income was made
* in favour of the Commissioner in relation to the application of Part IVA. This was on the basis that it was evident to the Court that the dominant purpose of the distributions of income to the relevant beneficiary was obtaining a tax benefit. In this regard, the income beneficiary was a company (taxed at 30%) that subsequently declared a franked dividend that flowed to a non-resident individual recipient, without the incurrence of further Australian tax liability, whereas if the distribution had been made directly to the non-resident income tax of some 47% would have been payable.

In view of these recent developments, additional care should be taken by trustees in exercising their discretion, having regard to any broader circumstances and objectives. Arrangements where the beneficiary of a distribution are purely tax motivated with the objective of another person ultimately receiving the benefit of the relevant funds are likely to be subject to increasing scrutiny.

* **TR 2012/D1: Income Tax: The meaning of ‘income of the trust estate’**

Draft Taxation Ruling TR 2012/D1 sets out the views of the Australian Taxation Office (ATO) on the meaning of ‘trust income’ following Bamford’s case. While the draft ruling is yet to be finalised (and may not be finalised in its current form) it is the most comprehensive outline of the ATO’s views on trust income to date.

Some of the key views outlined in the draft ruling are:

* notional amounts (e.g. franking credits) cannot form part of trust income
* the income of the trust estate for a year will be capped to any net ‘accretions’ to the trust (e.g. increases in the value of trust property)
* trust income which has been capitalised in prior years cannot be re-characterised as ‘income’ in the current income year.

When a Trust Deed defines trust income as net income under an income equalisation clause, trustees must be very careful when making an analysis of the income of the trust. This is because net income can often include notional amounts[[8]](#footnote-9) that, according to Draft Taxation Ruling TR 2012/D1, cannot form part of the income of the trust.

A common example of a notional amount is a franking credit which is included in assessable income (when a franked dividend is received). The ATO’s view is that a franking credit is a feature of the tax law that cannot be considered to be an accretion to the trust and as such will not be taken into account when working out trust income.

A trust with an ‘income equalisation’ clause (that is, a clause purporting to equate trust distributable income with its taxable income) that does not exclude franking credits from its calculation of trust income will in almost all cases inflate its calculation of trust income. This can lead to the following problems:

* an unexpected allocation of net income between beneficiaries
* a wastage of franking credits or
* the issue of a section 99A trustee assessment.

Other examples of notional amounts that are included in net income but may not be included in trust income are:

* Division 7A deemed dividends
* Liquidator’s deemed dividends
* trading stock revaluations (where the increase in value relates to a prior period)
* capital gains that have been inflated as a result of the market value substitution rule
* assessable gains under the taxation of financial arrangements provisions
* attributable amounts under the transferor trust provisions.
* **Effective trust resolutions**

From the year ended 30 June 2012 onwards a trustee of a discretionary trust should take care to ensure that its distribution resolutions are passed and documented at the appropriate time. This will generally be by 30 June of the relevant year (unless the Trust Deed requires this to be done earlier or in the case of streamed capital gains, as noted earlier).

It is critical that a resolution be made by the above date as this is an area that the ATO may scrutinise on audit. It should be noted that the ATO can, amongst other things, check computer records and forensically date the documentation to ensure a trustee has satisfied this requirement.

As the making of any resolution after year-end is invalid, any failure of the trustee to evidence the making of a resolution by year-end has the following detrimental consequences:

* no beneficiary will be taken to be presently entitled to trust income in which case the trustee will be assessed on the trust’s net income under section 99A of the *ITAA 1936,* typically at the effective highest marginal tax rate (plus Medicare levy) which is currently 47% or
* any default beneficiaries named in the Trust Deed will be proportionally made presently entitled to trust income in which case they will be assessed on an equivalent share of the trust’s net income.

In making an effective trustee resolution the trustee should determine how income is defined under the Trust Deed and refer to the specific clause in the Trust Deed which enables the trustee to exercise a discretion in distributing trust income to beneficiaries.

Such a resolution should be documented in writing and signed and dated by the trustee so that it can be objectively evidenced that the distribution is made prior to year-end.

The ATO has confirmed that a resolution made by a trustee does not have to specify a specific actual dollar amount in order for the resolution to be effective in making a beneficiary presently entitled to trust income.

Where a dollar amount is not specified, the resolution must prescribe a clear methodology which has been applied in calculating a beneficiary’s entitlement to trust income such as making each beneficiary presently entitled to a specific percentage of trust income for the relevant year.

Alternatively, the trustee may make one or more beneficiaries presently entitled to a specific amount with a single beneficiary being entitled to the balance of trust income.

A resolution may take the form of any of the following where there is a meeting of the trustee and their advisers:

* a file note recording the decision made by the trustee at the meeting which is completed before year-end
* an exchange of correspondence recording the exercise of the trustee’s discretion which is finalised before year-end
* a draft minute executed before year-end which formally records the trustee’s decision which is finalised after 30 June (if permitted under the Trust Deed).

However, in all cases, it is recommended that formal documentation of resolutions to reflect the above be prepared and signed as soon as possible.

Finally, it is necessary to consider the interaction of the specific entitlement and present entitlement rules where the Trust Deed includes an income equalisation clause equating trust income with the definition of net income under section 95(1) of the *ITAA 1936*.

Where such a clause applies, any net capital gain included in the trust’s net income will also be considered to be part of the income of the trust estate. Hence, where beneficiaries are made presently entitled to all of the trust income by year-end those beneficiaries will be distributed all of the net income of the trust for that year (including any assessable net capital gain) by virtue of the income equalisation clause. Accordingly, there would not be any remaining capital gain available to be subsequently streamed to another beneficiary by the following 31 August since the net capital gain will already have been effectively distributed in accordance with the allocation of net income to presently entitled beneficiaries.

Thus, where a Trust Deed includes an income equalisation clause it would be prudent for the trustee to make a beneficiary specifically entitled to any capital gain or franked dividend before making beneficiaries presently entitled to the balance of net income under the trustee resolution which must be made by year-end, being typically 30 June.

* **Trust Tax Return**

Trustees are required to disclose the income of the trust at Item 56 of the 2023 Trust Tax Return Form and at item 57 each beneficiary’s share of income of the trust. Care must be taken when completing this disclosure so that it properly reflects the terms of the Trust Deed and, where relevant, takes into account the ATO’s views of the meaning of trust income as set out under Draft Taxation Ruling TR 2012/D1 discussed above.

We note that the practical application of the above rules can often be difficult. Accordingly, if you have further queries on any details contained within this letter or have any other tax planning issues relating to the taxation of trusts, please contact me on [insert telephone number of partner].

Yours faithfully

**[Insert name of Partner]**

1. Provided that beneficiaries are presently entitled to all the income of the trust, all the net income (i.e. taxable income) of the trust will generally be assessed to the beneficiaries of the trust, with no amount falling for assessment in the trustee’s hands. [↑](#footnote-ref-2)
2. This will generally be its income calculated under general trust accounting concepts, as modified by any specific definition of income of the trust estate in the Trust Deed. [↑](#footnote-ref-3)
3. Refer to [Decision Impact Statement](https://www.ato.gov.au/law/view/document?DocID=LIT/ICD/S310/2009/00001) on *Commissioner of Taxation v* *Bamford & Ors;* *Bamford & Anor v Commissioner of Taxation.*  [↑](#footnote-ref-4)
4. Note that these amendments only relate to the streaming of franking dividends and capital gains. Consequently, the ATO considers that the streaming of other types of income will not be effective. [↑](#footnote-ref-5)
5. The trust estate’s income after excluding franked dividends and capital gains (to the extent they form part of the trust income) is known for the purposes of the *ITAA 1936* as ‘the Division 6E income’. [↑](#footnote-ref-6)
6. The trust estate’s net (taxable) income after excluding franked dividends and capital gains is known for the purposes of the *ITAA 1936* as ‘the Division 6E net income’. [↑](#footnote-ref-7)
7. In these circumstances the *ITAA 1936* will deem the income and the net income of the trust to be the Division 6E income and the Division 6E net income for the purpose of applying Division 6 in assessing the net income of a trust (excluding streamed capital gains and franked dividends) to beneficiaries. [↑](#footnote-ref-8)
8. These notional amounts would otherwise increase or decrease the calculation of trust income. [↑](#footnote-ref-9)