Advanced Income Tax Law

Chapter 2

Trusts

Overview

Definition of a trust

A trust is established whenever there is a separation of the legal ownership from the beneficial or real ownership of an asset. It is established under State law.

Trusts are not defined by the ITAA.

A trust of property or income may be described as a fiduciary obligation imposed upon a person (trustee) to hold property or income for a particular purpose, or for the benefit of others (beneficiaries).

Overview

Trusts are created for many purposes and come in many forms such as:

- trusts created to hold investment assets separately from personal or business assets, to provide staff and/or equipment, or to act as an employer entity.
- trusts set up under a will to ensure that the members of the deceased's family are provided for from the deceased's estate.
- superannuation (trust) funds established to provide superannuation benefits.
- property trusts used to hold property for the benefit of unit holders.

Trust Terminology

The following terms need to be understood in relation to trust law:

- Settlor
- Trust deed
- Trust property
- Trust Estate
- Trustee
- Beneficiaries
- Corpus
- Legal disability
- Present entitlement
- Inter-Vivos Trust
- Will trusts
- Vesting day

Trust Terminology

Settlor

is also called the ***creator***, and is the person who creates the trust and who transfers property to a trustee.

Under a trust deed the settlor is expressly excluded from ever being a beneficiary of the trust.

Trust deed

Is the written document that sets out various matters relating to the trust.

e.g. name of the settlor, trustee, beneficiaries, how long the trust is to last, powers of the trustee.

Trust Terminology

Trust property

is the property to which trust obligations arise.

may consist of money, real estate, shares, or personal property.

Trust estate

Is the trust property from which income may be derived.

Trust Terminology

Trustee

Has legal title to trust property under the terms of the trust instrument, but does not derive any benefit from that property.

A trustee may be a natural person or a company.

Owes a duty of care to the beneficiaries in relation to that property.

Trust Terminology

Beneficiaries

Are the persons, objects or purposes nominated to receive the benefit of the trust property.

A beneficiary does not have to be a person.

e.g. A trust could be established for the purpose of providing *"care and attention for lost dogs".*

Corpus

Is the sum of money or property that is set aside to produce income for the named beneficiaries.

Trust Terminology

Legal disability

Legal disability exists where a beneficiary:

- is a minor (infant) i.e. under 18 years

- is an undischarged bankrupt

- Declared legally incapable because of a mental condition

- is serving a prison sentence of 3 or more years

- cannot demand their share of trust income because of a condition of the trust instrument

Trust Terminology

Present entitlement

For a beneficiary to be presently entitled to trust income the following two conditions must be satisfied:

i. the trust income must be legally available for distribution to the beneficiary (i.e. the beneficiary has the right to demand immediate payment).

ii. the beneficiary must have an indefeasible and absolute interest in possession in the trust income.

Trust Terminology

Inter-Vivos trust

Is a trust created during the life of the settlor and operates during that period.

e.g. a discretionary trust established to conduct family business.

Will trusts

- arise from the death of the taxpayer.
- the income and assets (corpus) of the deceased estate are distributed in accordance with the terms of the will.

Trust Terminology

Vesting day

Vesting Day is the day that the Trust is to terminate, as stipulated in the Trust Deed or at such earlier date as determined by the Trustee.

On Vesting Day the beneficiaries appointed by the Trustee in accordance with the terms of the Trust Deed are entitled to the whole of the Trust Fund.

Liability of the Trustee

A trustee has legal title to trust property, but does not derive any benefit from that property.

Under tax law, a trustee is answerable as the taxpayer for the doing of all things required in relation to income derived by the trustee in a representative capacity.

A trustee is not personally liable for taxes payable by the trustee in a representative capacity, except to the extent of any failure to retain sufficient moneys to pay them.

Liability of the Trustee

The trustee may become liable for damages for any failure to comply with the terms of the trust deed.

A trustee is not personally liable for taxes payable by the trustee in a representative capacity.

Any liability to pay tax will be met from the trust estate income.

Types of Trusts

Discretionary trusts

The trustee has the discretion to vary proportions passed on to beneficiaries, or even vary the beneficiaries.

Fixed trusts

The beneficiaries receive specific proportions of the trust estate. The trustee has no authority to vary these proportions.

Unit trusts

Are a variation of fixed trusts. The beneficial ownership of the trust property is divided into a number of fixed units (e.g. property or cash management trusts).

Types of Trusts

Deceased Estate trusts

Arise from the death of a taxpayer.

Family trusts

Distributions are made to a defined set of family members.

Testamentary trusts

Is a trust established by Will where deceased estate property is held by the trustee on trust for beneficiaries.

Net Trust Income (NTI)

The net trust income of a trust is its assessable income for the year of income less deductions.

Note that trust deductions do not include personal expenses incurred or paid by the trustee on behalf of the beneficiaries.

Such payments are treated as distributions of s.95 NTI to the beneficiaries.

Net Trust Income (NTI)

Under s.95(1) NTI is:

Assessable Income

less

Deductions

equals

NTI

Taxation of Trusts

A trust is *not* a separate taxable entity.

However, a Trust tax return (Form T) must be lodged for a trust estate irrespective of the amount of income derived by the trust.

A Trust tax return requires the completion of a Statement of Distribution.

Taxation of Trusts

A trust is required to determine its net trust income and lodge an income tax return - **Form T -** irrespective of the amount of income derived by that trust.

Taxation - Trustee or Beneficiary?

The major difficulty lies in determining on whom, and in what circumstances, does the tax burden fall - on the trustee or on the beneficiary?

Taxing Trust Income

Trust income is taxed either to the beneficiary or to the trustee as follows:

The beneficiary is assessed if they are presently entitled to income of the trust estate, and are not under a legal disability.

The trustee is assessed on behalf of a beneficiary who is presently entitled but is under a legal disability.

Taxing Trust income

The trustee is assessed on net income of the trust estate to which no beneficiary is presently entitled.

If income is retained by the trust, the trustee is generally taxed at the highest marginal rate plus Medicare Levy.

Liability to Pay Tax

The trustee is assessed if:

A beneficiary is presently entitled or deemed presently entitled (under s.95A(2) ITAA36) but is under a legal disability then under s.98(1) & (2) ITAA36 respectively, the trustee is assessed on the share of NTI income on behalf of the beneficiary at ordinary rates of tax.

There is income to which no beneficiary is presently entitled the trustee is assessed under s.99A ITAA36 at a special penalty flat rate of 45% (plus Medicare Levy on the entire amount) for 2019/20.

Liability to Pay Tax

The beneficiary is assessed if:

They are presently entitled <u>and</u> not under a legal disability, then are assessed on their share of net trust income under s.97 ITAA36 at ordinary tax rates.

under a legal disability <u>and</u> are entitled to a share of income from another trust or derives income from other sources, then under s.100 ITAA36 that beneficiary must include income from all sources in their tax return and are accordingly assessed.

However, the beneficiary is also able to receive a tax credit for tax paid or payable by the trustee under s.98 ITAA36.

Taxation of Discretionary Trust Income

Where a beneficiary is not presently entitled to the net income of the discretionary trust, the tax liability will rest with the trust. This income is taxed at a flat rate of 45% plus Medicare Levy.

If the beneficiary is presently entitled and is not under a legal disability, they are liable for tax - **s.97 ITAA36** at ordinary marginal tax rates.

Taxation of Discretionary Trust Income

Where a beneficiary is presently entitled, but is under a legal disability, the trustee will be liable to pay tax on the beneficiary's behalf - **s.98 ITAA36.**

The Trustee may determine in a particular year not to distribute any proportion of the net income of the trust, but to accumulate that income as an addition to the Trust Fund.

In these circumstances, the Trustee is liable to pay tax on the net income of the trust at the highest personal marginal tax rate.

Discretionary Payments

Under **s.101 ITAA36** where a trustee is given discretionary power to make payments out of trust income to benefit a beneficiary such payments are *deemed to be distributions of income to which the beneficiary is presently entitled.*

e.g. school fees, medical expenses.

Discretionary Payments

Such payments are assessed by:

s.97(1) ITAA36 - beneficiary is assessed (when the beneficiary is not under a legal disability).

or,

s.98(2) ITAA36 - trustee is assessed (when the beneficiary has a legal disability).

Summary of Tax Liability

When a Beneficiary will be Taxed

In most cases a beneficiary will be assessed on trust estate income if they are:

- Presently entitled to any of the net income of the trust,
- Are not under a legal disability, and
- Are a resident for tax purposes for the year of income.

Summary of Tax Liability

When a Trustee will be Taxed

A trustee will be assessed on trust estate income when:

- A beneficiary is presently entitled to any of the income of the trust estate, but is under a legal disability.
- A beneficiary is deemed to be presently entitled to trust estate income (i.e. vested interest) but is not yet entitled to a distribution.
- A beneficiary is a non-resident for tax purposes for the year of income but is presently entitled to income of the trust estate.
- No beneficiary is presently entitled to any or all of the income of the trust estate.
- The trust is a revocable trust.

Deceased Estates

A deceased estate is a trust comprising:

- assets of a deceased person (the trust property),
- beneficiaries (usually those named in the deceased's Will), and,
- the executor (usually the legal personal representative) appointed in the Deceased's Will.

Deceased Estates

Role of Executor

The executor is responsible for:

- the collection of the deceased's assets
- payment of any outstanding debts
- making distributions to the beneficiaries in accordance with the terms of the will or legislation where there is no will
- notifying the ATO of the taxpayer’s death
- lodging tax returns on behalf of the deceased person
- paying taxes on all trustee assessments.

Deceased Estates

Administration period

- Is the time period between the deceased’s date death and the granting of probate.

- Until the administration of the deceased estate is complete, any income derived by the trust estate is regarded as income to which no beneficiary is presently entitled and is assessed under **s.99** or **s.99A ITAA36.**

- Generally, assessable income accrued at the date of the taxpayer's death, but which is received after that date is assessable to the trustee under **s.101A ITAA36.**

Deceased Estates

Probate

- Probate is granted by the Supreme Court in the State or Territory in which the will is lodged.

- Granting of probate means that the court recognises the Will as being both valid and authentic.

Illustration: Determination of administration period

Assume date of death is 31 July and probate is granted on 1 October.

Required: Determine the administration period.

Solution:

The administration period is 1 August to 30 September.

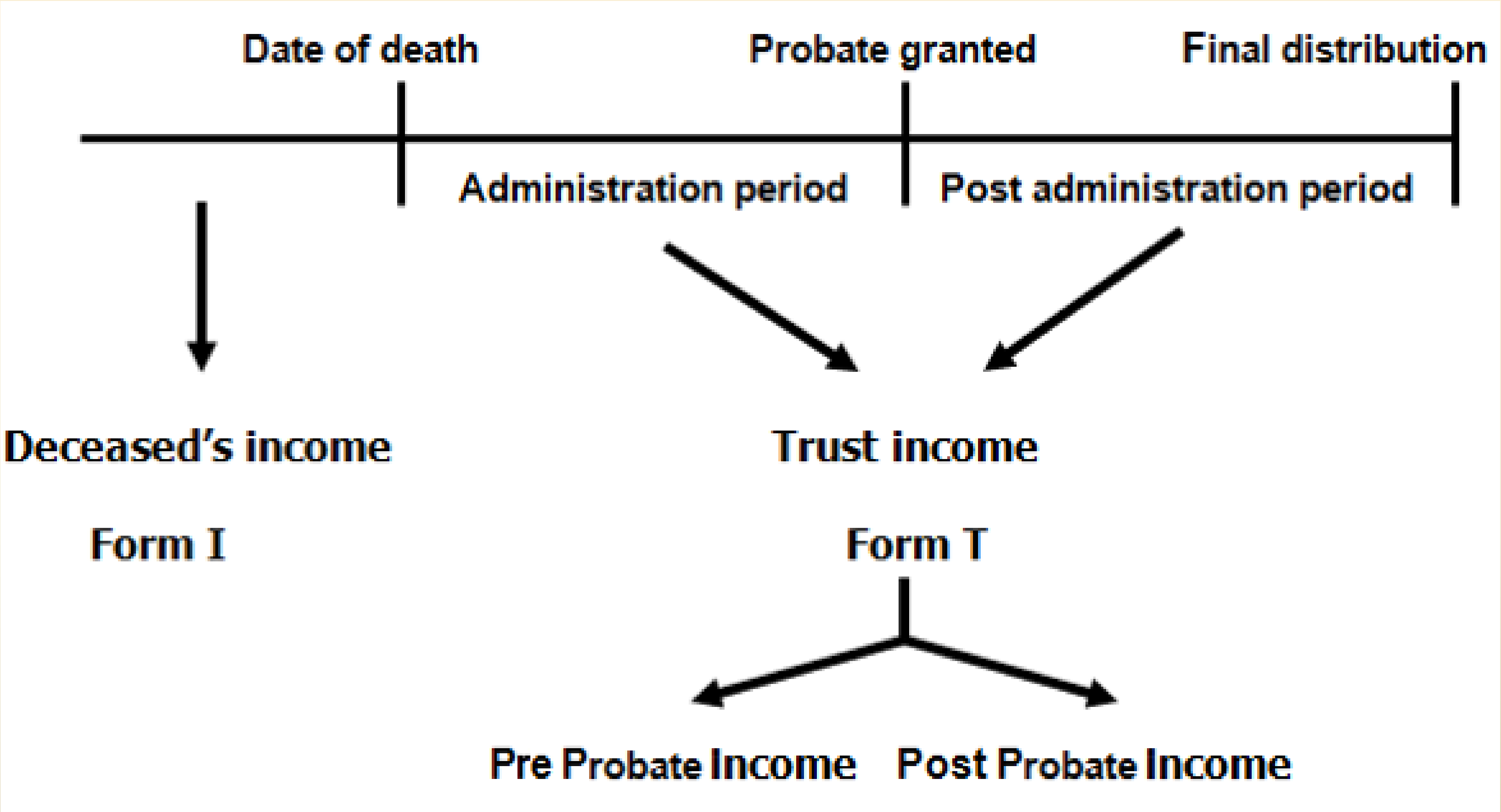
Deceased Estates

Post Probate

- Once probate has been granted the assets of the deceased estate should be distributed to the beneficiaries without delay.
- Any income derived post-probate is legally available for distribution.

Deceased Estates

Taxation of Deceased Estates



Deceased Estates

Taxation of Deceased Estates

Prior to probate	Post probate
Income prior to probate:	**Income post probate:**
is not legally available for distribution to the beneficiaries.	is legally available for distribution to the beneficiaries.
i.e. all income derived by the Estate during the prior to probate; **and** all income owing to the deceased at date of death, but which is collected after that date.	**i.e.** all income derived by the Estate after probate is granted, **except** for any income owing to the deceased at date of death but which is collected after that date.
forms part of the residue and is assessed against the trustee under **s.99**.	can be distributed to the beneficiaries and is assessed under **s.97** or **s.98** as applicable.

Tax Rates for Deceased Estates

Beneficiary not presently entitled

First three income years

For the first three tax returns, the deceased estate income to which no beneficiary is presently entitled is taxed at the general individual rates, with the benefit of the full tax-free threshold – **s.99 ITAA36**. No Medicare Levy is payable.

Fourth income year and later

For deceased estates with prolonged administration that extends beyond the concessionally taxed three year period, there are special progressive trust tax rates that apply. However, no Medicare Levy is payable.

Tax Rates for Deceased Estates

Beneficiary presently entitled and not under a legal disability

Where a beneficiary is presently entitled and not under a legal disability, that beneficiary is liable for any tax payable - **s.97 ITAA36**.

Tax Rates for Deceased Estates

Beneficiary presently entitled but under a legal disability

Where a beneficiary is presently entitled, but is under a legal disability, the trustee will be liable to pay tax on the beneficiary's behalf - **s.98 ITAA36**. The trustee will be assessed separately for each beneficiary in this category.

The general individual tax rates apply. Normally, unearned income of minors is subject to tax at higher rates and a lower tax-free threshold. However, for distributions from a deceased estate, the ordinary tax rates apply.

Trust Losses

Trust losses are retained in the trust and are *not* distributed to the beneficiaries.

Trust losses must be carried forward and offset against future trust income.

Trust Losses

Special trust loss tests apply to certain types of trusts such as discretionary and fixed trusts.

These tests must be satisfied before a carry forward trust loss can be deducted against current year trust income.

The tests are:

- 50% Stake test
- Income Injection test
- Pattern of Distributions test
- Control test

Beneficiary with No Interest in Capital

A life tenant is a beneficiary with an interest in the income of the trust for the duration of their life, but with no interest in the capital of the trust.

If the trust includes a beneficiary who is a life tenant or a beneficiary with no interest in the capital of the trust, a deduction for tax losses of earlier income years cannot be claimed in calculating the share of those particular beneficiaries in the net income of the trust if the tax losses of previous years are required to be met out of corpus.

Miscellaneous

Dividends

Franking credits are included in the calculation of **s.95NTI.**

Beneficiaries of a trust who are presently entitled to a part of the trust income that is attributable to franked dividend income are entitled to a franking tax offset for this income.

Trust Capital Gains/Losses

Capital gains/losses are included in the calculation of **s.95NTI.**

Trusts have access to both the general 50% CGT discount and the small business entity capital gains tax concessions where applicable.