THE TAX INSTITUTE

THE MARK OF EXPERTISE

Trust Structures Guide

11th edition

The ultimate resource for anyone advising on trusts, structuring and planning issues

Sladen Legal

Sladen Legal

A Tax Institute Publication

Publisher

Published in Australia in 2016 by
The Tax Institute ABN 45 008 392 372
Level 10, 175 Pitt Street, Sydney, NSW 2000
taxinstitute.com.au

Author

The Lantern Legal Group Pty Ltd ABN 98 076 868 034

National Library of Australia Cataloguing-in-Publication data:
Trust Structures Guide: structures, usage, implications, planning and much more.
11th ed. Includes index.
ISBN 978-0-9925810-0-8
1. Trusts and trustees – Taxation – Australia. **2.** Trusts and trustees – Australia
I. The Lantern Legal Group Pty Ltd (Firm) **II.** The Tax Institute.
343. 94064

Important disclaimer: This publication is intended as a guide only. The comments in this publication do not constitute legal advice and should not be relied upon as such. Where this publication indicates a particular trust structure is appropriate for a transaction, that indication is for the purpose of establishing a starting point for discussion. You should seek advice from a professional adviser regarding the application of any of the comments in this publication to a particular fact scenario.

The information in this publication is current as at 14 December 2015.

The Tax Institute and The Lantern Legal Group Pty Ltd exclude all liability (including liability for negligence) in relation to your use of this publication. You should rely on your own professional advice.

0415IP_08/13

Contents

Chapter 2: General structuring guide 45

Chapter 4: Alternative use of trust structures 187

Chapter 5: The standard private company as corporate trustee 215

Chapter 6: The difference between distributable and taxable income 219

About the author

Sladen Legal provides expert advice and legal services to private enterprise throughout Australia. The *Trust Structures Guide* reflects the skills, resources and commitment that the firm applies to the delivery of legal services.

Over many years, the firm has provided advice on the use of trusts and companies for business and investment structuring, asset protection, business succession planning and effective business operation. The structure diagrams and notes used in the *Trust Structures Guide* to explain how trust structures work and the benefits they provide were developed and used to assist clients and professional advisers.

These diagrams and notes have been highly valued by clients and professional advisers because of their conceptual, visual characteristics and clarity of expression. The recognition by clients and professional advisers of the value of the diagrams and explanatory material led to the development of the *Trust Structures Guide*.

Sladen Legal's commitment to excellence, diversity of skills and focus on specialisation has made it a leading provider of legal services in the areas of trusts and tax law. There is continual change in the law, change in the needs of clients, and change in the economy. Sladen Legal keeps not just abreast of change, but ahead of it.

Further enquiries on content in the *Trust Structures Guide*, the use of trusts and other entities or general legal queries should be addressed to trusts@sladen.com.au.

About the publisher

The Tax Institute is Australia's premier tax body. Since 1943, The Tax Institute has provided the tax profession with leading-edge education, information, support and an active forum.

Providing services to more than 35,000 professionals, membership currently stands in excess of 14,000, which includes a comprehensive cross-section of leading tax accountants, lawyers, tax agents, managers, academics and students.

As part of an ongoing commitment to members, The Tax Institute provides the best tax education available in Australia, delivered by the profession's leaders. Institute members have access to extensive continuing professional development (CPD), the highly valued *Taxation in Australia* journal, the *TaxVine* e-newsletter, and a vast array of products and services relevant to tax professionals.

In order to better serve the tax profession, The Tax Institute offers an innovative structured education program. With a practical and flexible approach delivered by leading tax professionals, the program is designed to complement existing CPD activities and support tax professionals throughout their careers.

Please direct any enquiries relating to membership, or purchasing options for this or any other publication, to membership@taxinstitute.com.au.

Preface

This publication provides detailed guidance on the many trust structures available for structuring family, business and investment arrangements, and the rationales for adopting these structures, such as effective asset protection, the maximisation of available tax concessions, and the organisation of business, investment and family relations.

Trust structures are widely used by many Australians to manage and protect their business, investment and personal assets. The separation of control and ownership of assets inherent to a trust provides asset protection planning opportunities. Despite the prevalence of trust structures, the complexity and changing nature of the law of trusts and the variety of trust structures available mean that the appropriate use and regulation of trusts is not widely understood.

This guide aims to provide clarity to professionals by explaining and illustrating the different types of trusts that should be considered when making any business or investment structuring decision. To ensure that the structure is suitable for the client's requirements, the guide takes into account real-life planning issues, as well as providing commentary on current legislation and case law. Simple language, checklists and descriptive diagrams endeavour to make this guide user-friendly and accessible for all professionals, whether a beginner or an expert.

With the Australian Taxation Office's continuing attention on trust structures, it is important that professionals keep well-informed of the tax issues specific to trusts. Chapters 6 and 7 of this guide, in particular, identify and explain important tax considerations that are relevant to the operation of trusts.

This publication has been revised to reflect the amending legislation and other developments that had become known by 14 December 2015.

Acknowledgments

The Lantern Legal Group (trading as Sladen Legal) and The Tax Institute would like to acknowledge the significant effort and contribution of Daniel Smedley (Taxation Law Specialist and Principal of Sladen Legal) in writing, compiling and overseeing the development of the early editions of the *Trust Structures Guide*.

Contributions from the following people to the 2016 edition are also gratefully acknowledged: Rob Jeremiah, Taxation and Business Law Specialist, Principal, Sladen Legal; Phil Broderick, Principal, Sladen Legal; Renuka Somers, Special Counsel, Sladen Legal; Amanda Morton, Special Counsel, Sladen Legal; Melissa Brazzale, Associate, Sladen Legal; Bonnie Temple, Associate, Sladen Legal; Will Monotti, Lawyer, Sladen Legal; Ashleigh Eynaud, Intern, Sladen Legal; and Patricia Martins, Legal Project Manager, Sladen Legal.

Sladen Legal would also like to acknowledge the exceptionally talented publishing group and consultants of The Tax Institute who have worked on all aspects of this publication and are helping to make The Tax Institute the publisher of choice for the tax profession, including: Alex Munroe (General Manager, Information Products); Renée McDonald (Publisher); Deborah Powell (Managing Editor); Louella Brown (Production Manager); Mei Lam (Designer); Stuart Murphy (Online Publishing); and Kristina Proft (Indexer).

Legislation reproduced

Chapter 1

Introduction

¶1-100 How to use this guide

1. Identify relevant issues and possible structures

Chapter 2 of this guide outlines issues that should be considered in making any business or investment structuring decision. Those issues should be reviewed and considered on each occasion a structuring decision needs to be taken. The flowchart "Which structure is right for you?" at ¶2-110 then identifies some of these issues and indicates which structure(s) would generally be the most appropriate.

2. Select a structure

There are many structures that can be used for businesses and investments. Some of these structures are detailed in chapters 3 and 4. Each structure is described by way of a "key points guide" and a "detailed guide". Those familiar with trust structures may simply refer to the key points guide, which outlines in an easy-to-read table format the suggested application of and parties to the structure and issues relevant to asset protection, income taxation, capital gains tax, succession planning and new investors. Those unfamiliar with a particular structure may wish to review the detailed guide that accompanies the key points guide for that structure. Ensure that the structure you choose is suitable for your requirements.

If you have any doubts, contact your professional adviser.

3. Request the documents you need

To establish a structure you will require certain documents (eg you may need a discretionary trust deed and a partnership agreement — and you may need to incorporate a company). To get these documents, contact your professional adviser.

4. Use the reference features of this guide

If you need any assistance with the basics of trusts, see chapter 1 of this guide. It explains the nature of trusts, describes the different types of trusts, provides a short history of trusts and trust law and has other useful information about the parts of a trust deed. Chapter 5 outlines similar information on companies. Chapters 6 and 7 identify and explain some important tax issues specific to the operation of trusts. Chapters 6 and 7 of the guide have relevance for all professionals, from beginners to experts. We recommend that you read chapter 1 first if you are new to this guide.

¶1-105 What this guide does

This guide outlines a number of business and investment structures that can be used to protect assets, maximise available tax concessions and organise business, investment and family relations in a logical way.

The guide comprises seven chapters:

- chapter 1 introduces the guide, describes how to use it and interpret the diagrams used throughout and discusses fundamental concepts relevant to trusts;
- chapter 2 outlines some issues that should be considered in structuring or restructuring business or investments and, through the use of a flowchart, indicates which structure should at first instance be considered;
- chapters 3 and 4 explain the various structures that may be used in any given business or investment scenario;
- chapter 5 discusses the liabilities of directors of corporate trustees. This information is particularly relevant to the management, control and operation of the corporate trustees of the trust structures described in this guide; and
- chapters 6 and 7 identify and explain important tax issues specific to trusts.

The following table illustrates which chapters of the guide are relevant to users with different levels of skill.

<table>
<tr><th colspan="2"></th><th>Beginners</th><th>Intermediate</th><th>Experts</th></tr>
<tr><td colspan="2">Chapter 1</td><td></td><td>✓</td><td></td></tr>
<tr><td colspan="2">Chapter 2</td><td>✓</td><td>✓</td><td></td></tr>
<tr><td rowspan="2">Chapter 3</td><td>Key points guide</td><td>✓</td><td>✓</td><td>✓</td></tr>
<tr><td>Detailed guide</td><td>✓</td><td>✓ (as required)</td><td></td></tr>
<tr><td rowspan="2">Chapter 4</td><td>Key points guide</td><td>✓</td><td>✓</td><td>✓</td></tr>
<tr><td>Detailed guide</td><td>✓</td><td>✓ (as required)</td><td></td></tr>
<tr><td colspan="2">Chapter 5</td><td>✓</td><td></td><td></td></tr>
<tr><td colspan="2">Chapter 6</td><td>✓</td><td>✓</td><td>✓</td></tr>
<tr><td colspan="2">Chapter 7</td><td>✓</td><td>✓</td><td>✓</td></tr>
</table>

WARNING! Part IVA ITAA36

The Commissioner of Taxation can investigate an arrangement that you set up. This would include the establishment of a new, as well as the amendment of an existing, business or investment structure. He can then determine that in his belief the arrangement contravenes the anti-avoidance provisions of Pt IVA of the *Income Tax Assessment Act 1936* (ITAA36). His position would rely on the argument that the arrangement was undertaken for the sole or dominant purpose of obtaining a tax benefit. You may be able to rebut the argument raised by the Commissioner of Taxation but this would involve expensive and time-consuming litigation with uncertain results.

Where the Commissioner of Taxation makes such a determination, he may cancel the relevant tax benefit and impose penalty tax.

Use of language in this guide

Solely for the sake of simplicity of expression, this guide uses the male form when discussing a person, such as a testator. Naturally, the same would apply for a female. As such, the expression "providing for the testator's spouse" does not necessarily indicate that the testator is a male as "testator's spouse" could refer to a female's husband. Furthermore, the term "trustee" is often used in a neutral gender. A trustee need not be a company and this gender may refer to an individual trustee. Finally, often the singular is used when it could, if the context so allows, include the plural. So when this guide mentions the trustee of a trust, it refers to each trustee of the trust if the trust has more than one trustee.

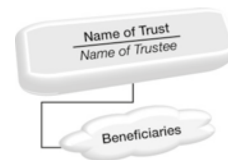
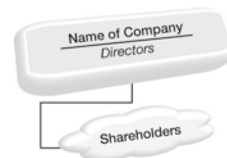
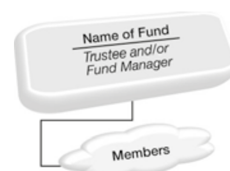
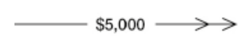
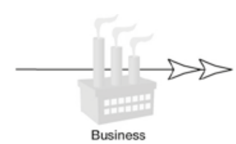
Availability of concessional tax treatment

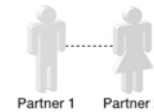
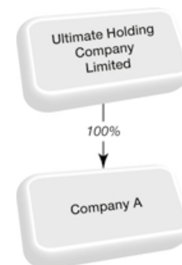
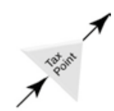
Whenever a key points guide says that a certain concessional tax treatment is available, it means that that tax treatment is generally available, subject to any applicable conditions discussed in the text and the particular fact scenario.

> It is important that you seek professional advice on each occasion that you want to access concessional tax treatment.

¶1-110 Symbols and diagrams used in this guide

Symbols

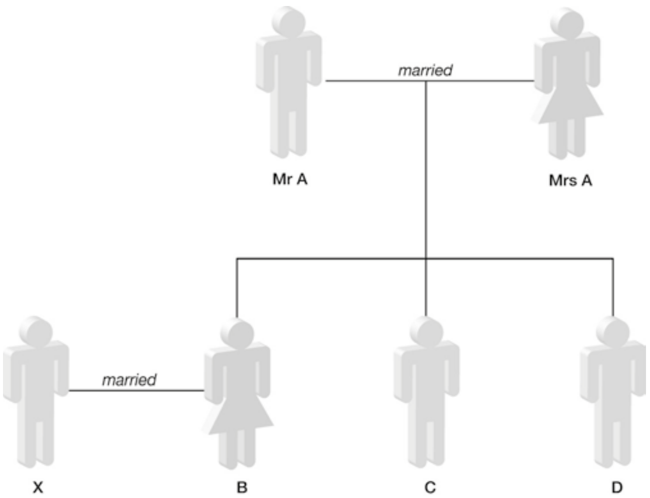
	Item	Description	Symbol
Entities	Trust	A box showing the name of a trust in bold, with the trustee in italics and beneficiaries below.	
	Company	A box showing the name of a company in bold, with directors in italics and shareholders below.	
	Superannuation fund	A box showing the name of a fund in bold, the trustee and/or fund manager in italics and members below.	
Transactions	Money	Refers to a payment of money, for example, consideration for a purchase, a distribution of dividend, income, or capital etc. The symbol is an open double-headed arrow indicating where the money is headed and with the amount shown.	
	Assets	Refers to a transfer or conveyance of goods, business, services or other assets etc. The symbol is a closed double-headed arrow indicating where the assets are headed and the type of assets.	

	Item	Description	Symbol
Relationships	Partnership	A broken line between outlined entities.	
	Ownership	An open single-headed arrow from the owning entity, pointing to the thing owned and possibly with the amount of ownership shown (eg in percentage form).	
Other	Expanded view	A curved arrow pointing to an expanded view (the expanded details of the trustee AB Pty Ltd being indicated here).	
	Tax point	A triangle in an arrow pointing to who is responsible for paying tax.	
	General assets	Refers to trust fund or company assets. The symbol is a share certificate (possibly with assets listed below).	
	Specific assets	Refers to assets such as real property. The symbol depicts the asset.	
	Australian resident	Refers to residents such as an Australian resident. Symbol includes a map of Australia next to a resident entity.	
	Foreign resident	Refers to residents such as a company incorporated in the UK. The symbol is a map of the relevant country next to a foreign entity (if the resident is simply foreign, then a map of the world is used).	

Diagrams

Family arrangement diagram

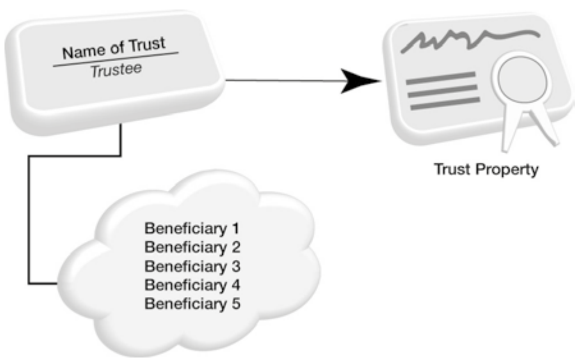
The following diagram shows a standard family arrangement. Mr A and Mrs A are married to each other. They have three children: B, C and D. B is married to X. The fact that each person in this arrangement is a natural person (rather than a company) is indicated by the human figure.



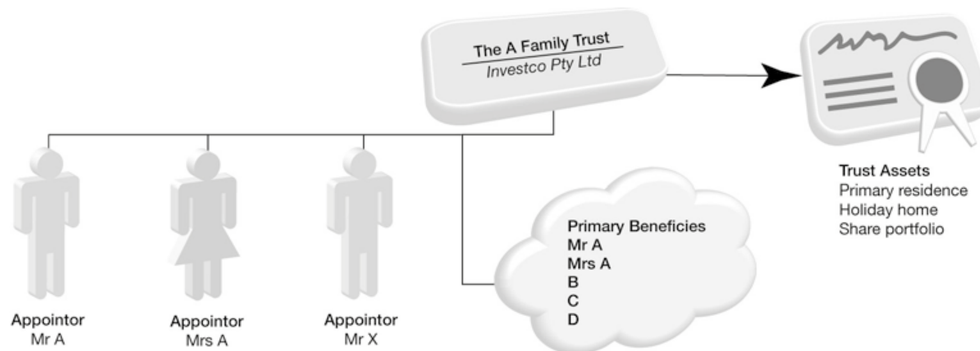
Accordingly, if you see a human figure on a diagram indicating, say, that the figure is "A", this shows that A is a natural person in the structure being illustrated.

Trust arrangement diagrams

The following diagram shows a standard trust arrangement. The diagram indicates that the arrangement is a trust and shows the name of the trust, the trustee of the trust and the beneficiaries of the trust; it also specifies the property that the trust holds (ie the trust fund). Other diagrams may show other features of the trust (eg the appointor or the settlor).

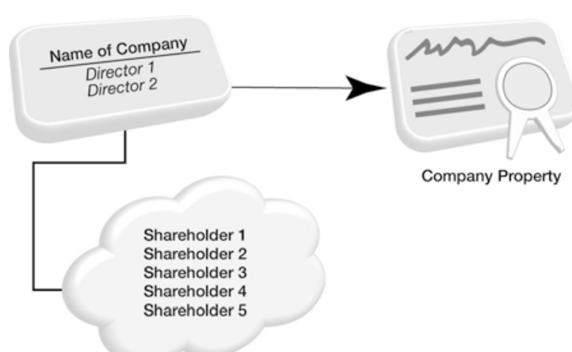


The following diagram shows an example of a family trust. The name of the trust is the A Family Trust. It has as the trustee Investco Pty Ltd and, as primary beneficiaries, Mr and Mrs A, and their children B, C and D. The trust fund comprises the A family home, the A family holiday home and the share portfolio. The trust is established with appointors (Mr A, Mrs A and Mr X) shown as follows:

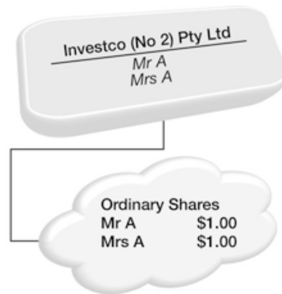


Company arrangement diagrams

The following diagram shows a standard company structure. The diagram indicates that the structure is that of a company and states the name of the company, the directors of the company and the shareholders of the company. It also specifies the property that the company owns. Other diagrams may show other features of the company (eg a complex shareholding arrangement).



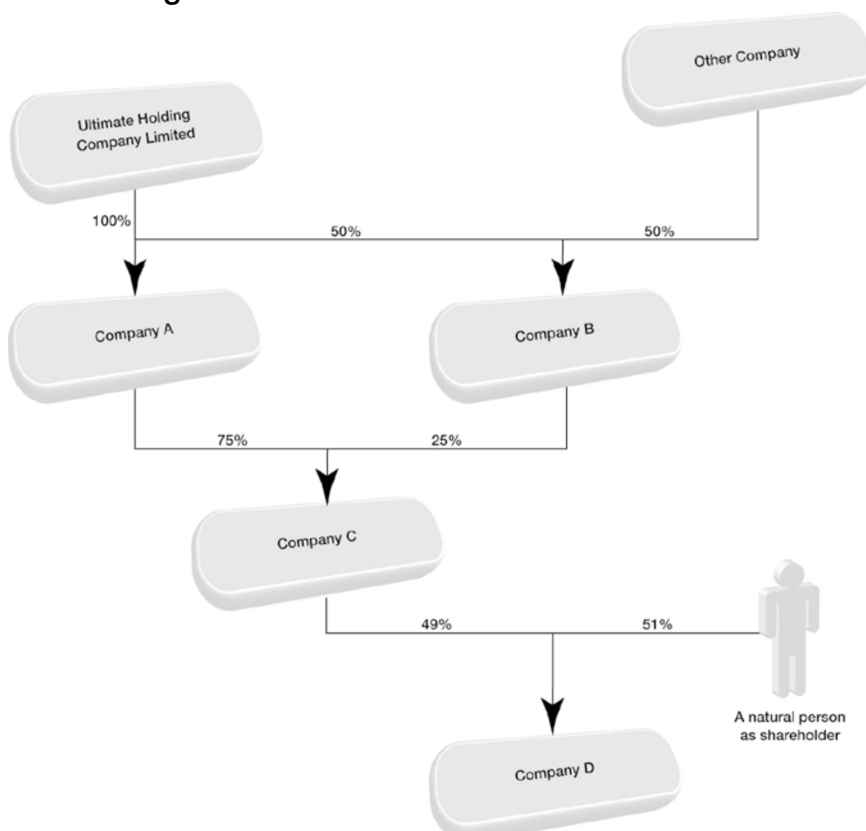
The following diagram shows an example of a simple company structure. The name of the company is Investco (No. 2) Pty Ltd. It has as directors Mr A and Mrs A. Mr A and Mrs A are also the shareholders in the company and each owns one ordinary share for which $1.00 has been paid. The shares are fully paid for because the shareholding is shown in bold. Accordingly, the share capital of the company is $2.00. The company has no assets (or, for the purpose of the diagram, it is not important to show the assets of the company).



Companies frequently own some or all of the shares in other companies. There are many company structures such as the one in the following diagram. Company A is a wholly-owned subsidiary of Ultimate Holding Co Ltd. Company A holds a 75% stake in Company C. Company B may be a joint venture vehicle for Ultimate Holding Co Ltd and Other Company.

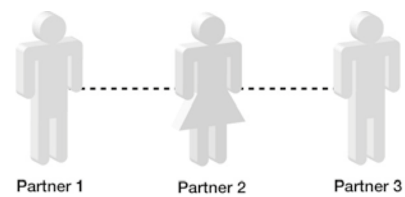
Lines with an open-headed arrow always point from the owner to the thing owned. So Ultimate Holding Co Ltd owns Company A and half of Company B in the following corporate structure diagram.

Corporate structure diagram



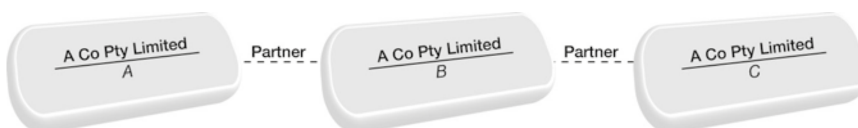
Partnership of individuals diagram

Partnerships in this guide are outlined and linked by a broken line. A partnership made up of natural persons looks like this:



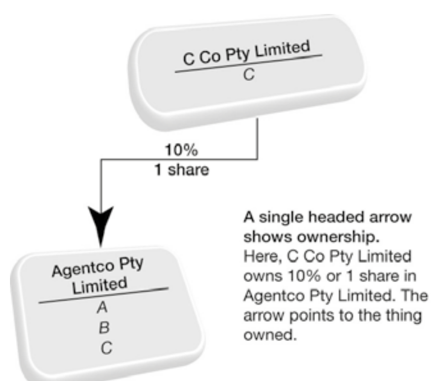
Partnership of companies diagram

A partnership made up of companies looks like this:

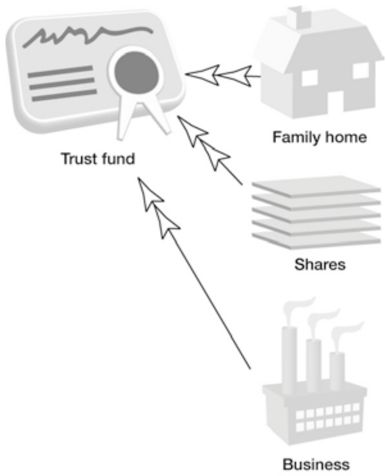


Ownership diagram

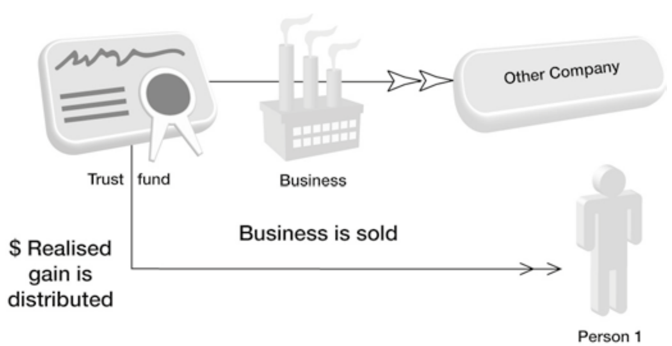
The following arrows show the following things:



Movement of money or goods diagrams



A double-headed arrow shows movement of goods or money. This can take the form of a transfer or a conveyance of property (such as those in the diagram above) with closed heads, or a distribution of money (eg the realised gains in the following diagram) with open heads.



¶1-115 The definition and nature of a trust

A trust is a relationship between a person (called the trustee) and another person (called the beneficiary) in which the trustee holds property (called the trust property or the trust fund) for the benefit of the beneficiary. Sometimes there is more than one trustee. Often there are many beneficiaries.

A trust differs from a simple ownership in property by having, as a necessary element in the relationship, the separation of the ownership of the legal interest in the trust property (held by the trustee) and the ownership of the beneficial or equitable interest in the trust property (held by the beneficiary). Where the legal ownership and the beneficial ownership in trust property merges in the same person, the trust dissolves and the person becomes the outright owner of the property.

The trustee may be the original owner of the trust property. If the trustee declares that it holds the property on trust, the trustee divests itself of the equitable ownership in the property and passes it to the beneficiaries. If the trustee is not the original owner of the trust property, the person who provides that property is known as the settlor.

A trustee is bound by the terms of the trust not to use the trust property for their own benefit but rather for the benefit of the beneficiary(ies).

A trustee has rights in rem in the trust property and the beneficiary has rights in personam against the trustee. This means that the trustee is able to deal with the trust property as they have legal, proprietary rights in it. The beneficiary has personal rights against the trustee and can bring an action against the trustee — for example, to have the trustee administer the trust in accordance with its terms.

A beneficiary also has an interest in the assets that make up the trust property and, through the law of tracing, may be able to follow them into the hands of a person not entitled to them. In this respect, the beneficiary, like the trustee, has certain rights in the trust property.

¶1-120 A short history of trusts

Before 1536, if A conveyed land to B, with the express or implied intention that B should not hold it for A's own benefit, but for the benefit of a third person C, then B was said to hold the land "to the use", that is, for the benefit of C. At common law, B was the owner of the land, the legal estate being vested in B. In the Court of Chancery, however, B was merely the nominal owner and was bound to allow C to have the profits and benefit of the land.

This "use" or equitable ownership was treated like an estate. It was devisable by will, although the land was not. A conveyance to uses enabled interests in land to be created and transferred with a flexibility and secrecy unknown to the common law; and it enabled the owners of land to evade inconvenient consequences arising from holding land.

Legislation passed by Henry VIII (the *Statute of Uses* (27 Hen. 8, c. 10)) in 1535 attempted to abolish uses because lawyers were adopting them to evade tax. The Act provided that where a person was vested of an estate of freehold to the use of another, the use should be converted into the legal estate and the beneficiary should become the legal owner. So, under the legislation, C became the outright owner of the property.

However, the legislation failed to destroy uses and equitable interests, owing to the decision in *Jane Tyrrel's* case (1557) Dyer 155a where it was held that, if there was a use following on a use (ie if A conveyed land to B so that B held it for the use of C on terms that C was to hold it for use of D), the statute executed the first use and was then exhausted so that the legal estate vested in C, who held it on behalf of D, who still had an equitable estate. The second use came to be known as a trust. A use had only to be expressed to shift the legal estate without formality.

Trusts have proved an extremely flexible and useful legal entity throughout the parts of the world that derive their law from England and much case law regulates them. Trusts continue to be used as favourable tax vehicles and to protect assets from creditors and court orders. They are used in estate and succession planning and in the administration of the property of people on their death.

Originally, courts separate from those administering common law administered the law relating to trusts. These days, courts that administer common law can also administer trusts and can offer equitable remedies to trustees, beneficiaries and others who are affected by a trust.

Statute law regulates trusts to this day. In Victoria, trusts are governed by the *Trustee Act 1958*. Unlike the King's legislation, the Trustee Act does not regulate trusts for tax purposes. It deals primarily with responsibilities of trustees.

The ITAA regulates the taxation of trusts. The ITAA is regularly amended, sometimes with retrospective effect. Indeed, the Treasurer often makes pronouncements concerning the taxation of trusts that have immediate effect (even if it takes parliament some time to get around to amending the ITAA). Accordingly, this guide can state the law only as it exists at the time of writing. *Please obtain specific professional advice before setting up any structure suggested by this guide if tax considerations are important.*

Finally, something just to note: anti-trust law is a legal concept in the United States. It refers to law that prohibits monopolies or anti-competitive practices. It does not refer to trust law in the sense that this guide does. When anti-competition law was first introduced in the late 1800s in the United States, before the rise of the popular use of corporate structures in commerce, industrialists had businesses tied up in trusts. This law attempted to break up these trusts and became known as anti-trust law.

¶1-125 The rule against perpetuities

The rule known as the rule against perpetuities is one of a number of rules developed by the English courts several centuries ago to impose some limits on certain restrictive dealings with property. These were largely dealings which had the potential to tie up property for a long period.

In its modern form, it is actually a rule against the remoteness of vesting and the word "perpetuities" is to some extent inappropriate. With a discretionary trust, the capital of the trust fund will not all be vested in beneficiaries until the trust is finally wound up. The rule against perpetuities applies to discretionary trusts to limit the life of the trust by providing that the whole of the trust fund must be absolutely vested in beneficiaries by the end of the perpetuity period.

At common law, the perpetuity period was the period of the life or lives in being (being one or more persons alive at the date of the creation of the trust and specified as the relevant persons for that purpose) plus a further period of 21 years. Any disposition of property (in this case, the settlement of the trust by the settlor) where the property may not have finally vested in a beneficiary absolutely within the perpetuity period was void from the outset. This is why older trust deeds often describe the vesting date of the trust as "That day which is 21 years after the date of death of the last to die of the descendants of King George V living at the date of this trust deed".

The common law rule has been modified by statute in all Australian states and territories. In South Australia, it has been abolished. There are some differences in detail between the legislation in other places but in general it provides either for a fixed perpetuity period (usually 80 years) or for the trust to specify a perpetuity period (usually with a maximum of 80 years).

It is beyond the scope of this publication to go into detail regarding the rule against perpetuities but there is one area in which there is the potential for it to be unwittingly breached and that is the area of trust-to-trust distributions. Many discretionary trusts include within their range of beneficiaries, other trusts, commonly those where a natural person beneficiary of the first trust is also a beneficiary. This raises the possibility of there being a distribution of income or capital from the first trust to the second trust. If that is to occur then consideration needs to be given as to whether the termination date of the second trust may be later than the end of the perpetuity period applicable to the first trust. If that is the case, the proposed distribution may breach the rule against perpetuities. It would not be void from the outset because of a "wait and see" rule in the legislation which provides that in such circumstances the disposition will not be void, provided it in fact does finally vest (in this case in a beneficiary of a second trust) within the perpetuity period applicable to the first trust. If it does not do so, the distribution will be void.

The operation of the "wait and see" rule was confirmed in the case of *Nemesis Australia Pty Ltd v FCT* [2005] FCA 1273 (*Nemesis*). In *Nemesis,* Tamberlin J of the Federal Court found that distributions from a trust (the first trust) to another trust (the second trust), where the termination date of the second trust is later than the first trust, is a breach of the rule against perpetuities, but that the "wait and see" rule means that the distribution will not be void until it becomes established that the vesting of the distribution must occur outside the perpetuity period of the first trust. In *Nemesis,* it was held that, as the trust deed of the second trust contained a power to bring forward the termination date of the second trust to a date before the first trust's termination date, it was not certain that any distribution from the first trust to the second trust would vest outside the first trust's termination date.

¶1-130 Types of trusts

There are many types of trusts. The types of trusts can be contrasted with each other by looking at their respective characteristics. The tables in this chapter illustrate the different types of trusts by distinguishing one trust from another and from other structures. Some trusts may have a combination of these characteristics, for example, a family trust is an express, private, discretionary trust.

Express trust	v	Implied trust
An express trust is one created by clear words that express an intention to create a trust. Express trusts are usually created by trust deeds. Trusts suggested in this guide are express trusts.		An implied trust is one implied by law as founded on the unexpressed but presumed intention of the parties or simply presumed by law. As there is no expressed intention to create a trust (simply one presumed by law based on the parties' intentions or otherwise), an implied trust is distinguishable from an express trust.

Constructive trust	v	Resulting trust
A constructive trust is an implied trust that arises by operation of law in order to satisfy the demands of justice and good conscience, without reference to any presumed intention of the parties. The law presumes the application of a constructive trust in many circumstances. For example, where a mortgagee sells property under a power of sale, the mortgagee becomes the trustee of any surplus realised by the sale for the benefit of the mortgagor under a constructive trust.		A resulting trust is an implied trust where the beneficial ownership in the trust property comes back (or "results"), to the person (or his representatives) who transferred the property to the trustee. The law presumes the application of a resulting trust in many circumstances. For example, where an express trust does not deal with the whole of the trust property, that property will revert back to the person who provided it to the trust.

Private trust	v	Public trust
A private trust is one established for the benefit of a particular individual or a group of individuals. Trusts suggested in this guide are private trusts.		A public trust (sometimes known as a charitable trust) is one established for the benefit of the public at large or a substantial portion of it. The law relating to taxation, certainty of beneficiaries and perpetuities that applies to public trusts is different to the law that applies to private trusts.

Discretionary trust	v	Bare trust
A discretionary trust is one in which the trustee has a wide discretion in relation to dealings with the trust property. Discretionary trusts are frequently used for distributing income among members of a family. A person who wishes to provide for the distribution of their property on their death uses a will. If the person wishes to provide for the distribution of their property (including income generated from the property) during their life, the person may establish a discretionary trust to do so.		A bare trust is one in which the trustee has no discretion in relation to dealings with the trust property, but only nominal legal control over it, and one duty, namely to convey the trust property on demand to a specified party. For example, where the trustee must follow a court ruling and convey land that the trustee owns to the purchaser of it.

cont …

Discretionary trust	v	Fixed trust
A discretionary trust is one in which the trustee has a wide discretion in relation to dealings with the trust property. The trustee can, for example, distribute income to one beneficiary and none to others. **Example: a family trust** A family trust is one established for the benefit of members of a family. Consequently, it is both a private trust and a discretionary trust.		A fixed trust is one in which each beneficiary has a fixed, or proportionate, interest in the income or capital of the trust. The trustee has no discretion in relation to distributing income or capital other than proportionately between the fixed entitlement holders. If the trustee makes a distribution of $100,000 of income, a holder of 18% of the income entitlements must receive $18,000. This trust is distinguishable from a discretionary trust. **Example: a unit trust** A unit trust is one in which the beneficial ownership of the trust property is divided into a number of units that are held by the beneficiaries. Each unit entitles its holder to receive a set proportion of the income and/or capital distributions of the trust.

Distinguishing features	Unit trust	Company	Partnership
Legal entity?	No (except for GST).	Yes.	No (except for GST).
Can sue and be sued?	No (but trustee and unitholders can).	Yes.	No (but all partners together can).
Member has beneficial interest in property?	Yes, a unitholder has a beneficial interest in the trust assets.	No, a shareholder has no beneficial interest in the company assets.	Yes, a partner has a beneficial interest in the pooled partnership assets.
Treatment of capital distributions?	A distribution made by a unit trust out of capital profits (or the extent to which a distribution comes from such profits) is a capital receipt in the hands of the unitholder.	A distribution made by a company out of capital profits is income and taxable as a dividend in the hands of the shareholder.	Each of the partners is entitled to a specific proportion of the capital of the partnership that, on distribution, is a return or payment of that entitlement.
Legal relationship between members?	The relationship between unitholders is regulated by trust deed. The relationship between the trustee and unitholders is regulated by trust deed.	The relationship between shareholders is regulated by the constitution (formerly known as the memorandum and articles of association).	The relationship between partners is regulated by the partnership agreement or (in Victoria) by the *Partnership Act 1958*.

¶1-135 Necessary elements of a modern express private trust

For a modern express private trust to be constituted:

- the trustee;
- the beneficiary; and
- the trust property

should all be determinable with certainty.

This remains the case regardless of how the trust is set up and whatever type of trust it is.

When establishing a trust, these three elements should always be clearly set out. Otherwise, the trust may fail.

Identifying beneficiaries

A well-drawn modern discretionary trust will usually have two classes of beneficiaries:

- Primary beneficiaries (sometimes called specified beneficiaries) who are often also the "takers in default" in relation to undistributed trust income. In a family trust these are commonly the husband and wife and their children.
- General beneficiaries which usually consist of:
  - a wide range of individuals related to the primary beneficiaries;
  - a range of companies and trustees of trusts in respect of which any one of the primary beneficiaries (or the individual general beneficiaries related to them) have an interest as shareholder or beneficiary respectively; and
  - additional members of the class of general beneficiaries which may be either those specified in the deed at the outset or added later through some nomination mechanism provided for in the deed.

There is then invariably a proviso that the settlor is excluded from being a beneficiary of the trust to ensure that s 102 ITAA36 does not apply.

Most deeds also have a mechanism for the trustee to exclude from the class of general beneficiaries a beneficiary that would otherwise be included. There is rarely a need to do this as a trustee can effectively exclude a beneficiary simply by failing to make any distribution of income to them.

It should accordingly be relatively easy to determine whether a particular person or entity is or is not a beneficiary of a discretionary trust but difficulties and errors are common.

Excluded beneficiaries

It is common for older deeds (even those only about 15 years old) to exclude as general beneficiaries of the trust some of the following:

- the guardian;
- the trustee;

- any corporation or the trustee of any trust in which the settlor, the guardian or the trustee have any beneficial interest or share or expectancy, as long as such interest or share or expectancy continues (sometimes absolutely and sometimes unless they are primary beneficiaries or specifically named in the schedule); and/or
- any notional settlor.

A notional settlor is usually defined as someone who has made any disposition of property in favour of the trustee other than for full consideration in money or money's worth.

Accordingly, any person or entity excluded from the class of general beneficiaries by the operation of these provisions will not be a beneficiary of the trust at all, unless they are a primary beneficiary.

Some deeds include in the class of general beneficiaries any corporation and the trustee of any trust which the trustee may from time to time nominate. However, where the exclusion includes any corporation in which the guardian has any beneficial interest, there is a potential problem. The guardian (not used so often now) was often one of the primary beneficiaries, so the question arises as to whether the nomination of the corporation in which the guardian held a share was an effective nomination of a beneficiary because it was made in accordance with the nomination provision, or whether the nominated company failed to become a beneficiary because of the operation of the exclusion provisions.

Some trusts are established with only one of the husband and wife nominated as the primary beneficiary and in some cases neither of them, with the children being the primary beneficiaries. That leaves the husband and/or wife who is not a primary beneficiary to take any income or capital distributions from the trust as general beneficiaries. This is not a problem unless they find themselves excluded by, for example, being a guardian, trustee or notional settlor (which they may become by making a gift of property to the trust or releasing an unpaid entitlement that they have, following a distribution of income in their favour).

The exclusion of the trustee as a general beneficiary probably has its origins in probate duty legislation (which was generally phased out about 20 years ago). The Victorian probate duty legislation included in the estate of the deceased (for the purpose of calculating duty) any property over which the deceased at the time of his death had a general power of appointment — that is, he had the power to distribute the property for his own benefit. If a person was the sole trustee of a discretionary trust of which they were also a beneficiary, then on their death the assets of the trust could be included in their estate for the purpose of calculating probate duty. Probate duty is well behind us but the exclusion of the trustee in many old deeds remains. It is yet another reason for having a company as a trustee of a discretionary trust rather than individuals.

Sometimes the settlor will be a relative of the primary beneficiaries. That will exclude the settlor from being a beneficiary of the trust, which presumably will not be a concern or it would not have occurred. It may, however, create an issue if the primary beneficiaries have a second trust established for their benefit by a different settlor. The settlor of the first trust, being a relative of the primary beneficiaries, may well be within the range of general beneficiaries of the second trust. That may result in the second trust being excluded as a beneficiary of the first.

Nomination of additional general beneficiaries

Apart from considering whether the proposed additional general beneficiary is within the range that the deed permits to be nominated, the nomination process in the deed itself needs to be followed. A few points to be noted:

- In some cases nomination in writing will be sufficient; in others the written nomination must be in the form of a deed.
- It is usually the trustee that is given the power of nomination but not always. In the case of *Idlecroft Pty Ltd v FCT* [2004] FCA 1087 (*Idlecroft*), the form of trust deed provided that the "principal" could, by notice in writing to the trustee, appoint a further beneficiary. In that case the nomination was held to be ineffective because it was done by the trustee, even though the principal was the sole director and secretary of the trustee and had signed the instrument of nomination. It was also held that the execution of the nomination document by the trustee did not amount to notice in writing by the principal to the trustee of the appointment as the trust deed required.
- The entity being nominated needs to be in existence at the time of the nomination. This seemingly obvious point was overlooked by the taxpayer in *BRK (Bris) Pty Ltd v FCT* [2001] FCA 164 (*BRK*). In that case, the trustee of a discretionary trust purported to nominate, as an additional beneficiary, a company in its capacity as trustee of a particular trust. At the time of the nomination that particular trust had not been established, with the result that the nomination of it as a beneficiary failed and a subsequent purported distribution of income to it failed also.

Renunciation of interest by beneficiaries

Pursuant to s 101 ITAA36, where income is advanced to or for the benefit of a beneficiary of a discretionary trust or credited to his or her account in the books of the trust, that discretionary beneficiary will be considered to be presently entitled to that income and will be assessed for tax purposes on this pursuant to s 97 ITAA36. The issues of trust income and assessable income are further discussed in chapter 6.

Where there is an ineffective exercise by the trustee of the discretion to pay or apply income for the benefit of a beneficiary but the trust deed contains a vesting clause that operates in default of an effective exercise of the discretion, the beneficiary or beneficiaries specified in that default vesting clause will be presently entitled to the trust income, as was the case in *Case* X40, 90 ATC 342.

Operation of the default vesting clauses may create instances where the default beneficiary has no knowledge of any such present entitlement, or even of the existence of the trust. However, in *Vegners v FCT* (1991) 91 ATC 4213 it was held that although an entitlement under a trust was valid notwithstanding that the beneficiary had no knowledge of it, the beneficiary could disclaim that entitlement on the entitlement coming to his or her knowledge.

In *FCT v Ramsden* [2005] FCAFC 39, the court held that for retrospective disclaimers made by the default beneficiaries to be effective, they needed to occur within a reasonable period after notice of the present entitlement and for the disclaimer to constitute a rejection of the beneficiary's entire interests in the particular gift. Lee Merkel and Hely JJ stated, "Whether or not the disclaimer must extend to the benefit of the trust as a whole depends on whether the provisions of the deed result in the making of more than one gift".

In *Alderton and FCT* [2015] AATA 807, the AAT held that, while the taxpayer had sufficiently evidenced a disclaimer of her interest in the trust, the disclaimer was not effective as it did not constitute an absolute rejection of the gift. The AAT understood that, having had use and benefit of the distribution, the taxpayer had accepted it and was no longer able to disclaim it. The case is discussed further at ¶7-100.

For a renunciation to be effective, any evidence of actual dissent may be sufficient. In *FCT v Cornell* (1946) 73 CLR 394, it was held that the renunciation need not be evidenced by deed. However, evidencing the renunciation by deed removes any ambiguity that may otherwise arise. Further, executing a deed within a reasonable period after notice of the present entitlement and ensuring the renunciation constitutes a rejection of the beneficiary's entire interests in the trust income will reduce the risk that the renunciation is deemed ineffective.

An argument may be raised that a trust is resettled if a beneficiary is removed from the trust by a deed of exclusion or a deed of renunciation. The issue of resettlements of trusts is discussed further in ¶7-125.

Another instance in which a beneficiary may decide to renounce their interest is in relation to an interest under a will or on intestacy. This may be done for a variety of reasons, including: a decision not to take anything from the testator on principle; in order to cause a partial or total intestacy which may suit the person disclaiming better; or the disclaimer may be designed to get away from burdensome provisions in the will, such as a conditional gift or life estate.

Further, where a beneficiary and appointor of a discretionary trust is receiving income support from Centrelink, they may wish to renounce their interest (particularly any default interest) to maintain their limits for means testing. Failure to do this may result in the beneficiary being unable to obtain that income support or pension.

Marriage breakdown

Commonly as part of a property settlement following a marriage breakdown one party will either retain or assume sole effective control of a discretionary trust. Care must be exercised in such situations. Take, for example, a situation where the wife was the sole primary beneficiary but the husband retained the trust after the property settlement. Following the husband's remarriage, his new wife's children would not be beneficiaries of the trust as they were unrelated to the sole primary beneficiary. This may be best remedied by nominating them as additional members of the class of general beneficiaries (or a variation to the trust deed if there was no nomination process available). If instead the primary beneficiary was changed the issue of resettlement needs to be considered. Resettlement issues are addressed in ¶7-125 of this guide.

Step-children are sometimes not within the range of general beneficiaries as they are not children of a primary beneficiary. "Spouse" will not include a de facto partner unless specifically so defined in the trust deed.

Income distribution to a non-beneficiary

A purported distribution of income by a trustee to a person who was not at the time of the distribution a beneficiary of the trust is void (*FCT v Ramsden* [2005] FCAFC 39 (*Ramsden*) and *BRK*). Where then does the income go? This will depend on the terms of the trust deed (subject to a valid waiver of entitlement by the beneficiary) (*Ramsden; Idlecroft; BRK* and *Pearson v FCT* [2005] FCA 250). A residue or balance clause in the distribution minute of the trustee will not be effective and the terms of the trust deed will prevail.

Accordingly, a resolution along the following lines:

> Resolved to distribute the net income of the trust fund for the year ending as follows:
> 1. $100,000 to [entity that is not a beneficiary];
> 2. the balance equally between [persons who are beneficiaries].

will *not* result in the $100,000 falling into the balance of income to be divided equally between the specified beneficiaries. The $100,000 distribution will fail entirely. Who becomes entitled to it (and obliged to pay the tax in respect of it) will depend on the provisions of the trust deed in respect of income in any year which is not the subject of an effective distribution by the trustee. Some deeds provide that this goes to the primary beneficiaries equally between them, which may not be entirely satisfactory if one of the primary beneficiaries is now an ex-spouse of the party having effective control of the trust. Other deeds provide that income not effectively distributed is accumulated. While this may result in the trustee being taxed on such amounts at the highest marginal rate that may, in the circumstances of a failed distribution, be the safest course.

¶1-140 A trust deed explained

A trust instrument establishes an express trust. The trust instrument is usually a deed because the beneficiary may not be providing any consideration under it. The trust deed contains clear words that show that the trustee declares that he holds certain property on trust for the beneficiary. Also, it will set out:

- who the trustee is;
- who the beneficiary is;
- what the trust property is;
- what powers the trustee has to deal with the trust property;
- what rights the trustee and the beneficiaries have in relation to the trust property and in relation to each other; and
- other relevant matters.

This section looks at the various parts of a trust deed so that a user will be able to understand one with greater ease and will be able to find things in a deed with greater speed.

Parts of a trust deed

A deed is an instrument in writing — signed, sealed and delivered — to prove and testify the agreement of the parties to the deed to the things contained in it.

A trust deed — basic checklist

- ☐ Date and party details
- ☐ Recitals
- ☐ Definitions
- ☐ Declaration of trust
- ☐ Beneficiaries
- ☐ Determine income
- ☐ Dealing with distributions
- ☐ Accumulation of income
- ☐ Income and capital streaming
- ☐ Appointment of capital
- ☐ Distribute an asset to a beneficiary
- ☐ Provisions that protect the trustee
- ☐ General powers of the trustee
- ☐ General duties of the trustee
- ☐ Specific powers of the trustee to deal with the trust fund
- ☐ Procedural provisions
- ☐ Vacation of office of trustee
- ☐ New trustee
- ☐ Amendment and variation
- ☐ Perpetuity period
- ☐ Appointor and dispute resolution mechanism
- ☐ Excepted trust proceeds
- ☐ Winding-up of trust

Date and party details	A trust deed, like other deeds and other written agreements, usually starts with the date and the party details. The date given in the deed, often defined as "the date of this deed", is important. Many trusts stop functioning 79 years following the date of the deed so as to comply with the rule against perpetuities. There is an explanation of this rule in ¶1-125 of this guide.
Recitals	Next come the recitals. Often they are headed "Whereas". Recitals set out the background to or the reasons for the parties entering into the deed.
Definitions	Terms used in a trust deed may be defined in the "Definitions" section of the trust deed. Definitions may or may not be capitalised. Capitalisation can make a difference to the term's meaning. If the word "Trustee" is defined as being "a Trustee of the trust established by this deed", then the use of the word "trustee" in "all the powers of a trustee" refers to the powers of a general trustee and not necessarily the powers granted to the trustee of the particular trust.
Declaration of trust	This will be a standard provision in which the trustee declares that it holds the trust fund on trust for the beneficiaries in accordance with the terms of the deed. All trust deeds should have a provision along these lines.
Beneficiaries	It is important the trust deed does not preclude the distribution of income or capital to a beneficiary as an unintended consequence of the drafting of the beneficiary provisions. Often beneficiaries are unintentionally excluded as beneficiaries of the trust fund by provisos to the definition of beneficiaries that preclude certain parties (such as appointors, trustees or the directors of corporate trustees) from receiving a distribution of income or capital from the trust. The way in which beneficiaries are described, particularly in older deeds, should be carefully reviewed. The issues involved in identifying beneficiaries are addressed in ¶1-135 of this guide.
Determine income	The trustee should have the power to determine what constitutes the "income" of the trust. Such a clause should be drafted in a flexible manner to ensure that the problems identified in chapter 6 of this guide are not encountered. One method of dealing with the problem is to: ■ provide the trustee with the power to determine whether receipts are to be treated as income or capital; and ■ to deem that in the absence of such a determination by the trustee, the income of the trust is equal to the net income of the trust under s 95 ITAA36.
Dealing with distributions	The deed should provide how the trustee can make distributions of income and capital to the beneficiaries. In a fixed unit trust the trustee will not have discretion as to how much each beneficiary or unitholder should receive by way of an income or capital distribution.

Accumulation of income	The deed often provides that the trustee can either distribute income to the beneficiaries at the end of each accounting period (this is usually a financial year) or accumulate it. When the trust accumulates income, it becomes part of the capital of the trust fund. The trustee may wish to accumulate income if the trust has incurred some debts that it must meet, such as re-organisational costs. However, the adverse consequence for an accumulation is that the trustee must pay tax on all the accumulated taxable income of the trust at the top marginal rate plus the Medicare levy. Usually, the trustee of a discretionary trust has the ability to determine whether to accumulate income or to distribute it to the beneficiaries, and the beneficiaries are unable to question the trustee's decision in this regard.
Income and capital streaming	Income and capital streaming provisions are important as they empower the trustee to separately record various categories of income and capital and then to distribute from those categories income and capital, to which attaches a particular characteristic to one beneficiary to the exclusion of the others. For example, in the simplest form, assume 50% of the income of a trust comprises franked income and 50% comprises unfranked income and there are two beneficiaries, an individual and a discretionary trust with losses. In this case, the trustee could separately record the franked and unfranked income in the books of account of the trust and then distribute the franked income to the individual and the unfranked income to the discretionary trust. If the appropriate provisions are included in a trust deed in relation to the streaming of income, all that is then required is for the trustee to use the trust's books of account to separately record income with particular characteristics attaching to it. Then, in the trustee minutes dealing with the distribution of the income, the trustee should separately identify which type of income is to be distributed to a particular beneficiary. Issues concerning the validity of streaming provisions for taxation purposes are addressed in ¶6-160 of this guide.
Appointment of capital	The trust deed should allow the trustee to appoint/distribute capital to beneficiaries prior to the vesting date. Trust deeds often provide the trustee with the power to advance a sum from the capital of a trust to a beneficiary. However, it is important that the trustee actually has a power to appoint/distribute capital to a beneficiary. Although such a power is useful in the day-to-day management of the trust, the power is particularly relevant where the trustee wishes to distribute (but not actually pay) amounts representing unrealised gains to beneficiaries of the trust.

Distribute an asset to a beneficiary	A trust deed often allows a trustee to distribute assets of the trust fund to a beneficiary in the form in which the trustee holds them. This is known as a distribution "in specie". Take, for example, a parcel of shares. Assuming that the trustee had determined to distribute capital to a beneficiary of an equivalent amount to the value of the shares and the beneficiary was interested not in the money realised by the sale of those shares but rather in the shares themselves, the trustee would be empowered to transfer the shares to the beneficiary. It will be prudent, in these circumstances, for the trustee to obtain an independent valuation of the trust property (including the shares) before distributing the shares. Issues concerning in specie distributions are addressed in ¶7-120 of this guide.
Provisions that protect the trustee	Many trust deeds contain provisions that protect the trustee either generally or specifically. General protection provisions remove the statutory standard that a trustee must follow. For instance, if the trustee is a professional, such as a lawyer, the Victorian *Trustee Act 1958* imposes a higher standard of duty on the lawyer as a trustee than it imposes on someone who is not a professional. The inclusion of such a clause means that the trustee must use ordinary prudence in carrying out the terms of the trust rather than following a higher standard. A specific protection provision protects the trustee in specific circumstances. For instance, a clause may provide that the trustee is deemed to have made a valid payment to a beneficiary if the trustee pays it into a bank account specified by that beneficiary. If, for whatever reason, the beneficiary does not receive that money, the trustee cannot be held liable to the beneficiary for a subsequent payment. Furthermore, trust deeds often contain an indemnity for the trustee. This means (in the absence of fraud or deliberate misfeasance) the trustee can recoup from the trust fund any liability it incurs for defending a legal claim against the trust — or simply for the day-to-day expenses of running the trust. Such a provision is necessary to ensure that the liabilities of a particular trust are actually borne by that trust rather than wholly by the trustee. Under the *Corporations Act 2001* (Cth), directors of a corporate trustee will be personally liable for debts incurred on behalf of the trust if the corporate trustee does not have a right of indemnity from the trust assets. Most financial institutions will require such an indemnity clause before lending to the trustee.
General powers of the trustee	Most trust deeds permit the trustee to deal with the trust fund to a certain extent. For example, the deed will allow the trustee to pay any tax it owes as a trustee. Also, the trustee may be empowered to do other things, such as introduce new beneficiaries to the trust. In a discretionary trust, the trust deed should provide that the trustee's discretion is absolute and uncontrolled and every power vested in the trustee is exercisable in its absolute and uncontrolled discretion. The trust deed should limit the trustee's power only in respect of varying the deed, or nominating or excluding a beneficiary. Where those restrictions apply, the trustee should be obligated to seek the written consent of the appointor.
General duties of the trustee	Most trustees are under an obligation to manage the trust in a certain way. That is, apart from their general duties as trustees, they are obliged to maintain certain records of dealings with the trust fund and to keep accounts and other records in relation to the trust.

Specific powers of the trustee to deal with the trust fund	The powers that the trustee has in dealing with the trust fund are usually set out in detail in the trust deed; in fact, these powers often run for pages. The deed outlines specific powers (eg whether the trustee is able to invest in the futures market). Often a trust deed will grant the trustee all the powers over the trust fund, as if the trustee were the legal and beneficial owner of it. Despite this all-encompassing power, the specific powers of investment of the trust fund are usually listed. If specific investment powers are listed, the trustee is generally limited to them, as someone dealing with the trust will probably wish to see a specific clause allowing the trustee to do certain things and will not be happy to rely solely on the general power. If, to continue the example, the trustee wishes to invest the trust funds in the futures market but cannot, expressly or by close implication, find an authorising power to do so, the safest course would be to seek to have the deed amended.
Procedural provisions	A trust deed sometimes sets out provisions that deal with procedural issues, such as how a meeting of beneficiaries with voting rights (eg unitholders) is to be held and what the unitholders in the meeting must do to pass a resolution. The deed could also specify how notice is to be given under the deed. A trust deed can be changed only by following the procedure for amendment outlined in the deed itself. It is difficult to change a trust deed that does not provide for amendment. Care should always be exercised when changing a trust deed so as not to cause a resettlement of the trust for CGT or stamp duty purposes. Resettlement issues are addressed in ¶7-125 of this guide.
New trustee	The trust deed should provide a means for an existing trustee to resign or be removed and for a new trustee to be appointed. Generally, the appointor provisions provide that the appointor may remove the present trustee and appoint a replacement trustee of the trust.
Appointor and dispute resolution mechanism	A dispute resolution mechanism should be included in the trust deed; the mechanism provides for the resolution of disputes between the persons comprising the appointors without the necessity to refer the dispute to a court. A well-drafted mechanism would provide that in the event of any one of the appointors being dissatisfied with the decision of the others, that one could serve a notice of dispute on them. The appointor provisions should also include automatic disentitling events that would result in an appointor ceasing to hold that position. A disentitling event would include the appointor becoming bankrupt, committing an act of bankruptcy, calling any meeting of creditors or entering into any assignment for the benefit of creditors or entering an arrangement with creditors. The provisions would result in the other persons comprising the appointor gaining effective control of the trust if one appointor suffered financial difficulties.

Excepted trust proceeds	The trust deed should allow the trustee of the trust to separately record and identify payments that comprise the excepted trust proceeds pool and to determine the income derived from the investment of those funds. Excepted trust proceeds have significant taxation benefits in respect of the taxation of infant beneficiaries. Generally the unearned income of persons under 18 years has a tax-free threshold of $416.00 (subject to any applicable low income rebates). Any unearned income in excess of the threshold is taxed at the top marginal rate. Section 102AG ITAA36 provides that income derived from specific assets transferred to the trust and distributed to persons under the age of 18 years is treated as excepted trust income; it will therefore be taxed in the hands of beneficiaries under the age of 18 years as adults (in other words, at the normal adult marginal tax rates). The specific assets that may be transferred include any benefit payable under the terms of a life insurance policy or a superannuation fund. For example, the life insurance policies of the primary beneficiaries of the trust could be paid into the trust fund after their death and those proceeds could then be maintained in a separate excepted trust proceeds pool. Any income derived from the investment of the amount in that excepted trust proceeds pool could be distributed to infant beneficiaries and taxed at the normal adult marginal tax rates. The payment of the proceeds directly to the trust should only be contemplated where it is inappropriate to pay those proceeds to a dependant of the primary beneficiaries.
Winding-up of trust	Subject to provisions in state legislation overriding the rule against perpetuities, the trust deed should provide that the trust is to be wound up by a certain date. Failure to include such a provision can render the entire trust void because it is likely in these circumstances that the rule against perpetuities or remoteness of vesting will be broken. Usually, the deed will empower the trustee to vest or wind up the trust before this specified date. The rule against perpetuities is considered in ¶1-125 of this guide.

¶1-145 Lost trust deeds

Despite the execution of multiple original trust deeds on the establishment of a trust, it is not uncommon that over time all original trust deeds and copies are lost. While the trust relationship will continue, administering the trust will be difficult and uncertain. Without a trust deed, the trustee may be unable to discharge its obligations to administer the trust in accordance with the trust deed, carry on a business, obtain finance and defend any revenue authority audit or assessment.

However, informal reinstatement of the trust deed such as the settlor, trustee and/or beneficiaries executing a “restatement deed” is likely to be ineffective or have adverse taxation consequences. In small trusts with passive income, it may be appropriate to administer the trust in accordance with trust law and the relevant Trustee Act. However, for large and complex trusts, it will usually be appropriate to apply for a court order that the unsigned execution copy or reconstructed copy of the trust deed stands in place of the terms of the original trust deed.

A thorough search may find an original or signed and stamped copy of the trust deed. If an unsigned execution copy of the trust deed is found or may be reconstituted from the trust deed provider’s files and precedents, the trust deed can likely be reinstated by court order.

It is therefore necessary to consider the options and risks associated with those options in dealing with lost trust deeds.

Investigations by the trustee

A trustee has the duty to ascertain the terms of the trust (*Hallows v Lloyd* (1888) 39 Ch D 686). Accordingly, the trustee is at least obliged to take all reasonable action to ascertain the trust's terms when a trust deed is lost. For practical purposes, the trustee will usually seek to do this in order that the trustee can properly administer the trust.

The trustee should undertake extensive investigations to locate an executed and stamped original or copy of the trust deed. Usually, the enquiries include contacting:

- all current and former trustees and directors of corporate trustees;
- the settlor;
- any current or former appointors and guardians;
- the trust deed provider;
- all adult relatives of the clients;
- adult beneficiaries;
- any legal personal representatives of the above;
- all current and former accountants and lawyers of the trust and adult beneficiaries; and
- all current and former financiers and brokers who may have obtained a copy of the deed as part of any finance application.

Documentation of those enquiries and responses is essential to establish a proper audit trail.

Copy trust deeds

If an executed and stamped copy of a trust deed is located, that copy (and copies of that copy) will constitute adequate evidence of, and stand as a sufficient substitute for, a lost original trust deed for most purposes (including litigation). In jurisdictions not subject to uniform evidence statutes, to use a copy document it is necessary to establish the loss of the original trust deed and the conduct of full investigations using a proper audit trail.

Often investigations will find an unsigned copy of the execution copy of the trust deed prepared by the trust deed provider. Alternatively, the trust deed provider may be able to provide a copy of the trust deed precedent that was current at the date of establishing the trust. The application form, file notes or other contemporaneous documents or the recollection of relevant persons may be sufficient to reconstitute the terms of the precedent trust deed. Such copy trust deeds may be sufficient to reconstruct the terms of the trust.

Class of beneficiaries

For fixed and unit trusts, the class of beneficiaries can likely be identified from collateral documents such as unit certificates.

For discretionary trusts, the past pattern of distributions disclosed in minutes and tax returns will identify some of the beneficiaries within the class of beneficiaries (if one assumes the valid appointment of the beneficiary). This may be sufficient for the continued operation of the trust where future distributions can be restricted to that identified but limited class.

The greatest uncertainty in reconstituting the terms of a trust is establishing the correct class of income, capital and default beneficiaries.

Minimum residuary terms

Where the trust deed is lost, trust law and the relevant state-based legislation (*Trustee Act 1958* (Victoria), *Trustee Act 1925* (New South Wales), *Trusts Act 1973* (Queensland), *Trustees Act 1962* (Western Australia), *Trustee Act 1936* (South Australia), *Trustee Act 1925* (ACT), *Trustee Act 1898* (Tasmania) and *Trustee Act 1893* (Northern Territory) (collectively referred to in this chapter as Trustee Acts)) will provide minimum obligations on and limited powers to a trustee. Although the enactments of the Trustee Acts were to provide powers in the absence of alternate or adequate powers in a trust deed, those powers are an effective default position when the trust deed is lost. Accordingly, where the trust deed has been lost, the trustee's powers will effectively be limited to those provided under the relevant Trustee Act.

As the relevant legislation is state-based, in this chapter, the following abbreviations will be used:

- Vic refers to *Trustee Act 1958* (Victoria);
- NSW refers to *Trustee Act 1925* (New South Wales);
- Qld refers to *Trusts Act 1973* (Queensland);
- WA refers to *Trustees Act 1962* (Western Australia);
- SA refers to *Trustee Act 1936* (South Australia);
- ACT refers to *Trustee Act 1925* (ACT);
- Tas refers to *Trustee Act 1898* (Tasmania); and
- NT refers to *Trustee Act 1893* (Northern Territory).

The operation of each of the Trustee Acts differs between each jurisdiction. In relatively passive trusts with passive investments such as shares and rental properties, the Trustee Acts' restricted powers are likely to be sufficient to enable the continued operation and administration of the trust in the absence of a trust deed. However, for trusts carrying on business, the restricted powers will invariably be inadequate.

Common law duties

A trustee's duties include the following:

- the duty to ascertain the terms of the trust;
- the duty to avoid conflict between the trustee's duty to the trust and personal interest which may impose an obligation on the trustee to account for profits or personally compensate the trust for any loss; and
- the duty to act fairly between the beneficiaries entitled to income and those entitled to capital.

In a modern deed, the trust deed often modifies or abrogates these duties to provide the greatest flexibility. In the absence of a trust deed, normal intra-family dealings may be restricted or unauthorised, decreasing the flexibility of the trust. Where a particular dealing may constitute a breach of these duties, often the beneficiaries can consent to and authorise the breach (*Walker v Symonds* (1818) 3 Swan 1 at 64). Alternatively, the beneficiaries who together are absolutely entitled under the trust may authorise and permit the trustee to depart from the terms of the trust.

However, the above is often a high-risk strategy as an errant beneficiary may frustrate the necessary consents. Further, without a trust deed it may be impossible to identify all the beneficiaries that must provide their consent. The court can excuse a breach where the trustee has acted honestly and reasonably, and ought fairly to be excused for the breach.

Trustee Acts statutory powers

The Trustee Acts each provide varying powers to assist in the administration of a trust. The particular Trustee Act may not provide a power or may impose restrictions or caps on a power. Refer to ¶1-150 of this guide for a review of some of the powers conferred on trustees by the Trustee Acts.

Depending on the assets and investment profile of the trust, it may be possible to continue the administration of the trust relying on trust law and the relevant Trustee Act without remedial action.

Trusts conducting a business

A trust is only entitled to carry on the business of the settlor or a testator where the trust deed or will expressly or implicitly permits (*Southwell v Martin* (1901) 1 SR (NSW) Eq 32; *In re Smith* [1896] 1 Ch 171). Only Queensland and Western Australia provide restricted rights to carry on a business for a period of up to two years or such period as may be necessary for winding up the business (s 57 Qld and s 55 WA).

Accordingly, the trustee of a trust carrying on a business will have little option but to take remedial action to reinstate the trust deed.

Tax administrative powers

The statutory powers do not include the traditional tax administration powers such as:

- classification and reclassification of income, capital and outgoings;
- allocation and reallocation of income, capital and outgoings;
- streaming classes of income and capital and related tax attributes; and
- discretion whether or not to recoup income or capital losses.

As a result of the recent amendments arising from the *Tax Laws Amendment (2011 Measures No. 5) Act 2011* (discussed at ¶6-160 of this guide), for income tax purposes, the failure to identify the streaming provisions in a trust deed may result in the inability to stream classes of income and capital with specific tax attributes to specific beneficiaries.

Expedient transactions

Where the trustee does not have the power to enter into a transaction under a trust deed (eg because the trust deed is lost) or statute, the court may authorise the trustee to enter into that transaction pursuant to s 81 NSW, s 94 Qld, s 59B SA, s 47 Tas, s 63 Vic and s 89 WA. Such court proceedings are relatively expensive. Accordingly, where possible, it would be more cost effective to reinstate the trust deed by court orders.

Reconstituting the trust deed

Memorandum of terms

Where investigations have found reliable evidence of the terms of the lost trust deed, it is appropriate to consolidate those terms and any explanation in a non-binding memorandum for ease of reference. Those terms can include the trust law principles and statutory powers under the relevant Trustee Act creating a virtual trust instrument. The trustee and the trustee's advisers will then have a clear document stating the powers of the trustee in administering the estate.

There is no implied or inherent trust law or statutory power vested in the trustee to amend the trust deed in the absence of an express power in the trust deed. An invalid amendment (*In re Cavill Hotels Pty Ltd* [1998] 1 Qd R 396), appointment of a trustee or appointment of a beneficiary (*FCT v Ramsden* [2005] FCAFC 39 and *BRK (Bris) Pty Ltd v FCT* 2001 ATC 4111) is void ab initio ("from the start"). Without a copy of the trust deed or a variation deed that recites the exact wording of the variation power, any attempt at reconstructing the trust deed that legally binds the trustee and the beneficiaries is likely to be ineffective.

Restatement deeds

To avoid the costs of obtaining a court order in order to reinstate the trust deed, some commentators and advisers have suggested that a combination of the settlor, the trustee and beneficiaries should execute a legally binding restatement deed recording the identified or assumed terms of the lost trust deed as a substitute for the lost trust deed. This is likely to be ineffective or have adverse taxation consequences.

Even if the relevant persons can execute a legally binding restatement deed, this is unlikely to be effective for tax purposes. It is incorrect to assume that the Commissioner is required to levy tax in accordance with a restatement deed under the principles that the tax law operates in accordance with and subject to the position at law and equity (*MacFarlane v FCT* (1986) 67 ALR 624; *Zobory v FCT* (1995) 129 ALR 484) and in accordance with the taxpayer's actual activities (*Tweddle v FCT* (1942) 180 CLR 1). Although the parties may agree among themselves on their contractual rights and obligations, such agreement does not bind third parties such as the Commissioner (*Davis v FCT* (2000) 171 ALR 654; *Hawley Partners Pty Ltd v Commissioner of Stamp Duties (Qld)* 96 ATC 4847).

Further, the onus will be on the taxpayer to show that the terms of any restatement deed are sufficiently similar to the terms of the trust deed and that there is no creation of a new trust or resettlement.

In the absence of a signed and stamped copy trust deed, the trustee should not attempt to create a replacement trust deed as this will likely constitute the creation of a new trust or resettlement of the trust. Even where an unsigned execution copy or precedent copy of the trust deed is obtained from the trust provider, execution or adoption of that trust deed by the trustee is likely to constitute a new declaration of trust.

Court proceedings

Where an unsigned execution copy of the trust deed is located or is reconstructed from the trust deed provider's file, the court can order that the unexecuted or reconstructed copy of the trust deed stand as the terms of the trust in place of the terms of any deed or other document expressed to contain those terms. In Victoria, the appropriate originating motion is pursuant to order 54.02 of the *Supreme Court Rules*.

The trustee as plaintiff initiates the originating motion and the settlor (if alive) should consent to the application. It is good practice for the principal beneficiaries of the trust to also be plaintiffs.

Affidavit material by the settlor (if alive), the trustee or the original and current directors of a corporate trustee, or the principal beneficiaries is prepared and filed in support of the originating motion. The matters dealt with in the affidavit material will likely include evidence of:

- the due and valid establishment of the trust;
- the terms of the trust;
- the continued administration of the trust;
- the assets that constitute the trust fund;
- the purpose of the trust and how the proposed orders will give effect to that purpose;
- the enquiries undertaken to locate the original trust deed; and
- any explanation for the loss of the original trust deed.

A successful court order will reinstate the terms of the trust in a form that provides certainty for the administration of the trust.

¶1-150 Trustee powers

The primary source of powers granted to the trustee of most trusts is the relevant trust deed. In each state and territory in Australia there is also a statutory framework that confers particular powers on trustees. The statutory powers are generally subject to the terms of the trust deed, which can operate to expand, restrict or vary the powers granted by law. In particular cases, however, the statutory powers operate notwithstanding the terms of the trust deed.

This chapter outlines the most useful and generally applicable powers conferred on trustees by statute. For convenience, it also focuses on trustees of discretionary trusts, although many of the powers discussed are also relevant to trustees of other commonly used trusts, such as unit trusts, hybrid trusts, and to some extent, superannuation funds.

As the relevant legislation is state-based, in this chapter, the following abbreviations will be used:

- Vic refers to *Trustee Act 1958* (Victoria);
- NSW refers to *Trustee Act 1925* (New South Wales);
- Qld refers to *Trusts Act 1973* (Queensland);
- WA refers to *Trustees Act 1962* (Western Australia);
- SA refers to *Trustee Act 1936* (South Australia);
- ACT refers to *Trustee Act 1925* (ACT);
- Tas refers to *Trustee Act 1898* (Tasmania); and
- NT refers to *Trustee Act 1893* (Northern Territory).

Although trustees are generally not required to provide reasons to justify the manner in which they choose to exercise their powers, it is important to be aware that the powers are always subject to the duties of the trustees, particularly the duty to exercise their powers honestly and only for the purposes for which they were granted. The beneficiaries may take action for breach of trust if the powers of the trustee are not exercised properly. (This was demonstrated in *Segelov v Ernst & Young Services Pty Ltd* [2015] NSWCA 156, where a beneficiary of the Ernst & Young Services Trust brought an action against the trustee of the trust alleging breaches of duty. Refer to ¶1-155 of this guide for a summary of some of the key issues raised by the case.) While the powers together may appear wide, each power only extends as far as is necessary to enable the trustees to perform their functions. If there is more than one trustee, they are required to act jointly in the exercise of their powers unless expressly authorised to do otherwise.

Powers in relation to trust property — general

Power of sale

In Queensland and Western Australia, s 32(1)(a) Qld and s 27(1)(a) WA grant trustees a wide power of sale, where trustees have a general power to sell trust property or any part of it. In New South Wales, Victoria, South Australia and the ACT, where trustees are authorised by the trust deed to pay or apply funds from trust capital for any purpose or in any manner, they are deemed by s 38(1) NSW, s 20(1) Vic, s 28B(1) SA and s 38(1) ACT to have the power to raise those funds by the sale of all or any part of the trust property. In Victoria and South Australia, the sections referred to above apply notwithstanding anything to the contrary in the trust deed. There is no general power of sale in Tasmania or the Northern Territory.

Power of investment

Until recent times, trustees were authorised by statute to invest trust funds only in investments chosen from a specific list. Section 14 ACT, s 14 NSW, s 5 NT, s 21 Qld, s 6 SA, s 6 Tas, s 5 Vic and s 17 WA are the relevant legislative provisions in each Australian jurisdiction conferring a general power of investment, and trustees may, unless expressly prohibited by the trust deed, invest trust funds in any form of investment and vary the investments at any time. This general power of investment is always subject to the "prudent person" rule, which requires that if the trustee's profession, business or employment is or includes acting as a trustee or investing money on behalf of other persons, the trustee must, in exercising powers of investment, exercise the care, diligence and skill that a prudent person engaged in that profession, business or employment would exercise in managing the affairs of other persons. If the trustee is not engaged in such a profession, business or employment, the legislative trust provisions in each Australian jurisdiction requires the trustee to exercise the care, diligence and skill that a prudent person would exercise in managing the affairs of other persons.

Section 14C ACT, s 14C NSW, s 8 NT, s 24 Qld, s 9 SA, s 8 Tas, s 8 Vic and s 20 WA set out a list of matters to which trustees should have regard when exercising their power of investment, and further sections in the legislation in each of those jurisdictions provide that in any action for breach of trust in relation to investment, the court may consider whether the trustee considered these matters, whether the investments were made pursuant to an investment strategy, and whether the trustee acted on independent advice.

Power to obtain audits and valuations

Trustees, under ss 51 and 52 NSW, ss 26 and 27 Vic, ss 51 and 52 Qld, ss 51 and 52 ACT and ss 50 and 51 WA, are given absolute discretion to obtain audits of the accounts of the trust property, and to have properly qualified agents ascertain and fix the value of any trust property. There is no equivalent power in the Trustee Acts in the Northern Territory, South Australia or Tasmania.

Power to carry on a business

At common law, trustees are not permitted to carry on a business without express authority from either the trust deed or the relevant court (*Kirkman v Booth* (1848) 11 Beav 273). In Queensland, this position has been altered by statute, and trustees are empowered to carry on a business for two years from the commencement of the trust or such period as may be necessary for the winding-up of the business. In exercising the statutory power of s 57 Qld, trustees are authorised to take various actions, including using, increasing or diminishing the trust property, purchasing goods such as stock and machinery, and employing workers. Section 55 WA applies the same power in the case of trustees of deceased estates only. There is no equivalent power in the other Australian jurisdictions.

Powers in relation to trust property — real property

Power to lease

In several jurisdictions, trustees are given the power to grant leases over real property held on trust. Under s 32(1)(d) Qld and s 27(1)(d) WA, the power is to grant leases:

> *… at a reasonable rent for any term not exceeding one year, or from year to year, or for a weekly, monthly or other like tenancy or at will.*

Under s 36(1) NSW, s 25C(1) SA and s 36(1) ACT, the length of time for which a lease may be granted in each of these jurisdictions is dependent on whether the trustee has a power of management or a duty to sell with an express power to postpone the sale. There is no general power to lease conferred by statute in Victoria, Tasmania or the Northern Territory.

Power to mortgage

Where a trustee is authorised by the trust deed or by law to pay or apply funds from trust capital for any purpose or in any manner, s 38(1) NSW, s 45 Qld and s 38(1) ACT permit the trustee to mortgage the trust property. This is also applicable in s 28B SA, s 43 WA and s 20 Vic, with the additional provision that this power applies notwithstanding anything to the contrary in the trust deed. No such power exists in Tasmania or the Northern Territory.

Power to repair and improve trust property using trust funds

Under ss 33(1)(a) and 33(1)(b) Qld, s 30 WA and ss 82 and 82A NSW, trustees in those jurisdictions are empowered to effect repairs and improvements to trust property using trust funds up to certain monetary limits. In South Australia, s 25A(1)(a) SA permits trustees to effect all repairs and improvements to trust property which in the opinion of the trustee are necessary or proper for the preservation of the building erections or fixtures or to render them tenantable. In New South Wales, the power only exists where its exercise would, in the opinion of the trustees, be in the interest of all persons beneficially interested in the land, and the expenditure must be from capital. Sections 82 and 83 ACT allow expenditure from capital or income, but apply only where a leasehold interest is vested in a trustee for a child or in trust for any person in succession. There is no equivalent power in Victoria, Tasmania or the Northern Territory.

Power to insure

Section 41 NSW, s 23 Vic, s 25 SA, s 18A NT, and s 41 ACT permit trustees in those jurisdictions to use income to insure against any risk or liability against which it would be prudent for persons to insure if they were acting for themselves, provided that the amount insured does not exceed the full value of the property. Similarly, s 46 WA provides that the maximum amount to be insured is the replacement value. Under s 47 Qld, insurance may be funded from income or capital. In Tasmania, trustees are empowered, under s 21 Tas, to use income to insure against the loss or damage by fire of any building or other insurable property, other than any building or property that a trustee is bound forthwith to convey absolutely to any beneficiary on being requested to do so, to any amount, including the amount of any insurance already on foot, not exceeding three quarters of the full value of such building or property.

Powers in relation to beneficiaries

Powers of maintenance (periodic payments)

Sections 43 and 44 NSW confer on trustees an absolute discretionary power to apply income or capital for the maintenance, education and benefit of an infant beneficiary, provided that if capital is to be used for this purpose, the trust property or the share of the property to which the infant is entitled must not exceed $4,000. The ACT holds a similar position under ss 43 and 44 ACT, except that the limit is half the value of the property or the relevant share of the property.

In Queensland and the Northern Territory, the relevant provisions in respect of maintenance payments to infant beneficiaries are s 61 Qld and s 24 NT, respectively. Section 62 Qld and s 24A NT provide that, where a person is entitled to the capital of the trust or any share thereof, the trustee may pay or apply for the maintenance, education, advancement or benefit of that person at the trustee's discretion an amount not exceeding $2,000 or half of the capital, whichever is greater.

Sections 33 and 33A SA, ss 58 and 59 WA, and ss 37 and 38 Vic allow for the application of income or capital, and the power is not restricted to infant beneficiaries. In Western Australia and Victoria, under s 59 WA and s 38(1) Vic, respectively, the application of capital for the maintenance of beneficiaries is limited to the greater of $2,000 or half the capital or relevant share of it, and in South Australia, under s 33A(1) SA, to half the capital or relevant share. Under s 63 Qld and s 60 WA, trustees may impose conditions on the exercise of the power. There is no power of maintenance in Tasmania.

Power of advancement (one-off outlay for a specific purpose)

Under s 44 NSW, trustees are permitted, at their absolute discretion, to apply capital for the advancement or benefit of any beneficiary, not exceeding half the value of the property or beneficiary's share. A similar limitation is imposed in the ACT, under s 44 ACT, and Tasmania, under s 29 Tas. As outlined above, in the Northern Territory, this power is limited, under s 24A NT, to $2,000 or half the capital, whichever is greater. In Victoria, South Australia, Western Australia and Queensland, trustees may apply income or capital for this purpose under ss 37 and 38 Vic, ss 33 and 33A SA, ss 58 and 59 WA, and ss 61 and 62 Qld. The application of capital for the advancement of a beneficiary is limited in Western Australia under s 59 WA, Victoria under s 38(1) Vic, and Queensland under s 62(1) Qld, to the greater of $2,000 or half the capital, and in South Australia under s 33A(1) SA, to half the value of the property or the beneficiary's share of it. Trustees in Queensland under s 63 Qld, and Western Australia under s 60 WA, may also impose conditions on the exercise of the power of advancement.

Powers to apply to the court

Power to apply to court for powers not otherwise granted

Where trustees wish to enter into a transaction in the best interest of the trust estate but lack the power to do so, one or more of them may apply to the court to enable them to enter the transaction. The power may be conferred unconditionally or subject to such conditions as the court sees fit.

Power to apply to court for variation of trust

In Queensland, South Australia, Western Australia, Tasmania and Victoria, trustees may apply, under s 95 Qld, s 59C SA, s 90 WA, ss 13 to 15 of the *Variation of Trusts Act 1994* (Tas) and s 63A Vic, respectively, to the court to vary or revoke the terms of the trust. This power can be used where rectification of a trust deed is required. The power is not conferred on trustees in the other jurisdictions.

More powers and the trust deed

The analysis of powers outlined above is not exhaustive. There are various other powers conferred on trustees by statute in each jurisdiction, which apply to a range of specific circumstances. In particular, the powers explored by this chapter are those that are most relevant to the operation of discretionary trusts, and different types of trusts will attract different powers.

It is important to remember that the statutory powers do not operate alone, and are, in almost all circumstances, subject to everything contained within the trust deed. The application of the statutory powers must always be interpreted with reference to the trust deed. While familiarity with the relevant statute can provide a useful starting point for understanding the general powers available to trustees, it is never possible to ascertain the full range of powers available to the trustees of a particular trust without a detailed analysis of the trust deed.

There are many powers that do not appear in the statutory schemes but which are important for the effective operation of many trusts, and so need to be included in trust deeds. These include a general power to delegate, a power to act notwithstanding personal interests, a power to give guarantees, a power to make in specie distributions, and a power to make elections for tax purposes. A properly drafted trust deed will contain a wide range of powers, which should make the need to resort to the relevant statutory powers a rare case.

¶1-155 The fiduciary obligation of trustees

In addition to the various powers described earlier in this guide, a trustee must perform or abstain from performing various acts. These duties are not limited to those described in the trust deed but also encompass obligations imposed on a trustee by the general law as established by case law.

The trustee has many duties. It is beyond the scope of this guide to provide a comprehensive list of such duties. However, a useful starting point may be found in the list of trustee duties identified by the Commissioner in the form "Self managed super fund trustee declaration". The document identifies as trustee duties the obligation to:

- *act honestly in all matters concerning the fund* [trust];
- *exercise skill, care and diligence in managing the fund* [trust];
- *act in the best interests of all the members* [beneficiaries] *of the fund* [trust];

…

- *ensure that my* [the trustee's] *money and other assets are kept separate from the money and other assets of the fund* [trust];
- *take appropriate action to protect the fund's* [trust's] *assets (for example, have sufficient evidence of the ownership of fund* [trust] *assets)*;
- *refrain from entering into any contract, or do anything, that would prevent me* [the trustee] *from, or hinder me* [the trustee] *in, properly performing or exercising my* [the trustee's] *functions or powers as a trustee or director of the corporate trustee of the fund* [trust];
- *allow all members of the fund* [trust] *to have access to information and documents as required …*
- *… prepare, implement and regularly review an investment strategy having regard to all the circumstances of the fund* [trust] …;

Amendments for context are in square brackets.

Although the list relates to superannuation funds the duties have equal application to the trustees of express private trusts. In addition to the above general duties a trustee of an express private discretionary trust also has obligations:

- to act impartially between the beneficiaries; and
- to not delegate the trustee's duties or powers.

These duties are fiduciary in nature. A fundamental aspect of the fiduciary relationship is that a person with fiduciary duties must not act in circumstances where there is a potential conflict of interest with the person to whom the duties are owed. Lord Scarman in *Queensland Mines Ltd v Hudson* (1978) 18 ALR 1 stated:

> *The law governing the liability to account of one who is in a special fiduciary relationship with another has been authoritatively declared by the House of Lords in Phipps v Boardman [1967] 2 AC 46 ; [1966] 3 All ER 721. Though their Lordships in that case differed in their analysis of the facts, they were agreed on the law. They accepted (see Lord Hodson (AC at 106; All ER at 745)) that the general principle was as stated by Lord Cranworth LC in Aberdeen Rly Co v Blaikie Brothers (1854) 1 Macq 461 at 471; [1843-60] All ER Rep 249: "And it is a rule of universal application, that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect."*

In modern trust structures where an individual may hold the office of sole director of the trustee company, be named as a primary beneficiary or be otherwise included within the class of discretionary objects, and also be nominated as the appointor or guardian in the trust deed, it is difficult to contemplate how that individual can effectively perform their fiduciary duties without a conflict of interest.

That said, where the modern trust structure contains special mere powers the potential to challenge the exercise of those powers and the proper exercise of the fiduciary duty is limited although still possible. Recent case law suggests that such challenges may become much more prevalent in the future as control of the modern trust structure drifts outside of a tightly held family unit to wider family groups or successive generations, as was demonstrated in *Hancock v Rinehart* [2015] NSWSC 646.

The ability to challenge the exercise of the trustee's discretion and the nature of the fiduciary obligation of trustees is examined through some recent cases below.

Curwen v Vanbreck Pty Ltd

Curwen v Vanbreck Pty Ltd [2008] VSC 338 involved a consideration as to whether the trustee's exercise of a power to exclude beneficiaries was invalid.

When considering the ability to challenge the trustee's exercise of the power to exclude beneficiaries under the trust deed, Mandie J considered the relevant law and summarised the principles as follows:

> *Applicable principles*
>
> *[50]*
>
> *Before considering the competing submissions advanced by the parties, I note that there was considerable common ground between them as to the applicable principles of law.*
>
> *[51]*
>
> *The parties accepted that, if the relevant discretion of a trustee was absolute and uncontrolled (and there was some dispute as to whether it was in this case), the applicable principles were as stated by McGarvie J in Karger v Paul [[1984] VR 161 at 163-164]:*

> *... with one exception, the exercise of a discretion in these terms will not be examined or reviewed by the courts so long as the essential component parts of the exercise of the particular discretion are present. Those essential component parts are present if the discretion is exercised by the trustees in good faith, upon real and genuine consideration and in accordance with the purposes for which the discretion was conferred. The exception is that the validity of the trustees' reasons will be examined and reviewed if the trustees choose to state their reasons for their exercise of discretion.*

> *…*
>
> *[53]*
>
> *As was noted by Beach J in Asea Brown Boveri Superannuation Fund No 1 Pty Ltd v Asea Brown Boveri Pty Ltd [1999] 1 VR 144 at 155-157], Karger v Paul had been followed and applied in various Australian jurisdictions in the case of exercises of discretion by trustees of superannuation funds. Beach J referred to what was said by Hayne J (as he then was) in Esso Australia Ltd v Australian Petroleum Agents' and Distributors' Assn [Supreme Court of Victoria, unreported, 5 October 1993]. In the latter case, Hayne J said that the principle stated by McGarvie J had long been held to be the law.*

The comments clearly identify the three bases on which the exercise of a purportedly unfettered decision making power may be challenged, being that the exercise of the discretion was not made in good faith, on real and genuine consideration, and in accordance with the purposes for which the discretion was conferred.

It is important to understand that the ability to examine the trustee's reasons lies in enabling an analysis as to whether the exercise of the discretion meets those three criteria above and does not exist to examine the manner in which the discretion was exercised. Mandie J stated:

> *[54]*
>
> *It emerges from the foregoing that, although a trustee's reasons for exercising a discretionary power are not examinable for the purpose of challenging the way in which the discretion was exercised, they are examinable to enable an enquiry as to whether the trustee had an ulterior or improper purpose and as to whether the trustee gave real and genuine consideration to the exercise of the discretion.*

In *Curwen v Vanbreck Pty Ltd*, the principal issue was whether the exercise of the trustee's power to exclude the beneficiaries was exercised for the improper purpose of preventing access by the beneficiary to trust accounts or other information relating to the trust. Mandie J held that if this was indeed a purpose in exercising the power to exclude the beneficiaries, it would be an improper use of that power. However, in the circumstances of the case such a conclusion could not be reached as Mandie J was not satisfied on the balance of probabilities that that improper purpose was one of the trustee's purposes in exercising its power to exclude the beneficiaries. The plaintiff failed on lack of evidence to support their argument.

The decision also identified the difficulty in assessing whether the trustee has acted on real and genuine consideration in the context of modern trust structures. Mandie J observed:

> *[55]*
>
> *Nevertheless, that aspect of the principle which requires that the trustee act upon "real and genuine consideration" has its difficulties in cases where the trust deed does not provide any governing criteria for the exercise of the power concerned and the trustee is left entirely at large in deciding whether and how to exercise the power [See DM Maclean, Trusts and powers, The Law Book Company Limited, 1989, pp 48-51].*

A useful analysis of the law pertaining to the requirement to exercise real and genuine consideration was undertaken by Byrne J in *Sinclair v Moss*.

Sinclair v Moss

When considering the law, albeit limited to the issues in *Sinclair v Moss* [2006] VSC 130, Byrne J stated as follows:

The legal principles applicable to this case which I apply were not seriously in controversy.

(1) The onus of establishing that the discretion in the year miscarried lies upon the plaintiff. [Guazzini v Pateson (1918) 18 SR (NSW) 275 at 289, per Street CJ]

(2) The Court will interfere where a clear case is made out [Turner v Turner [1984] Ch 100 at 111, per Mervyn Davies J. See too, Sieff v Fox [2005] 3 All ER 693 at 719 [82], per Lloyd LJ …] that the discretion is not exercised upon a real and genuine consideration of the matter entrusted to the trustees' discretion [Rapa v Patience (unreported) SC (NSW), McLelland J, 4 April 1985, at 11, BC8500888; Telstra Super Pty Ltd v Flegeltaub (2000) 2 VR 276 at 283 [26], per Callaway JA]:

"If it can be shown that the trustees considered the wrong question, or that, although they purported to consider the right question they did not really apply their minds to it or perversely shut their eyes to the facts or that they did not act honestly or in good faith, then there was no true decision and the court will intervene," [Dundee General Hospitals Board of Management v Walker [1952] 1 All ER 896 at 905, per Lord Reid.]

(3) A discretionary determination may be impugned if the trustees in making it failed to take into account matters which are relevant [Edge v Pensions Ombudsman [2000] Ch 602 at 619], that is, matters which they should have taken into account or which should have affected their decision or where they took into account matters which they should not have taken into account. [This case, as presented, did not involve a contention that the trustees took into account a matter which they should not have taken into account.] The importance of the word "should" in this context is emphasised in the 1993 decision of Hayne J in Esso Australia Ltd v Australian Petroleum Agents' & Distributors' Assn [1999] 3 VR 642 at 652 [41]:

"The bare fact that there was material that was not placed before the trustee and which the trustee might have taken into account is not to say that the trustee should have considered it. Thus proof that there was material not considered by the trustee and which was material that the trustee might have taken into account does not show that the decision is ill founded."

(4) This principle, which is referred to in England as the Rule in Hastings-Bass [Re Hastings-Bass decd; Hastings Bass v Inland Revenue Commissioners [1975] Ch 25], is there said to contain the further requirement that, had the trustees taken into account the matter which they should have taken into account but did not, they would not have exercised their discretion in the way that they did. There seems to be some uncertainty whether the Rule in Hastings-Bass is accepted as the law in Victoria. [See ASEA Brown Boveri Superannuation Fund No 1 Pty Ltd v ASEA Brown Boveri Pty Ltd [1999] 1 VR 144 at 154 [32] ff, per Beach J.] Principal (3), however, is well established by the cases to which I have referred. In argument before me nothing was made of the Hastings-Bass gloss.

(5) Notwithstanding that it is not a case where the trustees provided reasons for their determinations, the Court may examine the material available to the trustees and enquiries which they did or did

not make in order to determine whether they took into account matters which they should have taken into account.

"As part of the process of, and solely for the purpose of, ascertaining whether there has been any such failure, it is relevant to look at evidence of the inquiries which were made by the trustees, the information they had and the reasons for, and manner of, their exercising their discretion. However, it is not open to the Court to look at those things for the independent purpose of impugning the exercise of discretion on the grounds that their inquiries, information or reasons or the manner of exercise of the discretion, fell short of what was appropriate and sufficient. Nor is it open to the Court to look at the factual situation established by the evidence, for the independent purpose of impugning the exercise of the discretion on the grounds the trustees were wrong in their appreciation of the facts or made an unwise or unjustified exercise of discretion in the circumstances. The issues which are examinable by the Court are limited to whether there has been a failure to exercise the discretion in good faith, upon real and genuine consideration and in accordance with the purposes for which the discretion was conferred. In short, the Court examines whether the discretion was exercised but does not examine how it was exercised." [Kargar v Paul [1984] VR 161 at 164, per McGarvie J]

(6) Where the trustees make a determination after taking into account all matters which they should have taken into account, the Court will not interfere with the determination on the ground that the trustees made an error in their assessment of fact.

(7) There may be a point of distinction between a discretion which is unfettered or absolute and that which requires the trustees to be satisfied of or to form an opinion about a fact. [See Telstra Super Pty Ltd v Flegeltaub (2000) 2 VR 276 at 283 [25], per Callaway JA. Compare at 285 [33] per Batt JA.] …

(8) Where, as here, the trustees are required to take into account a particular matter, it is part of the decision-making process that the trustee make some effort to form a view upon that matter. [Scott v National Trust for Places of Historic Interest or Natural Beauty [1998] 2 All ER 705 at 717, per Robert Walker J; Telstra Super Pty Ltd v Flegeltaub (2000) 2 VR 276 at 284 [28], per Callaway JA; Abacus Trust Co (Isle of Man) v Barr [2003] Ch 409 at 415, [16] per Lightman J.] What those efforts might be will depend upon the circumstances.

[18]

I have expressed the above propositions in terms restricted to the relatively confined issues in this case. There is no allegation that the trustees' power was exercised in bad faith or for some ulterior purpose …

In this case, the provisions of the trust deed required the trustees to take account of the income requirements of a beneficiary when determining how to distribute income from the trust. In some years of distribution, the trustees did not take those matters into consideration but instead followed the advice of their accountant to distribute income in a particular way. These distributions were held to be invalid as the trustees had not exercised their discretionary powers in accordance with the provisions of the trust. This was so even though one of the persons claiming that the distributions were invalid was also one of the trustees who made the previous decisions.

Segelov v Ernst & Young Services Pty Ltd

In the recent case of *Segelov v Ernst & Young Services Pty Ltd* [2015] NSWCA 156, proceedings were brought by a beneficiary of the Ernst & Young Services Trust (the trust). The trust was a discretionary trust with a large class of beneficiaries. The appellant was a beneficiary of the trust by virtue of being the spouse (at the relevant times) of a partner of Ernst & Young. The appellant argued that the trustee had a duty to inform her on becoming entitled to a distribution that she was a beneficiary under the trust, and a duty to ensure that she received the benefit of any distribution to her. The appellant alleged that the trustee had breached these duties by failing to notify her of her entitlements under the trust, and that the trustee was not entitled to be discharged by a receipts clause in the trust deed as payments made into a joint bank account prior to the end of the financial year were not payments of "income" of the trust fund (as defined under the trust deed).

The Court of Appeal found in favour of the respondent trustee. It was held that the trustee had a discretion as to how much income (if any) may be applied by the trustee in each financial year, and under the terms of the trust deed was permitted to make interim distributions of "income". The interim payment into the joint bank account was held to be a dispositive act, and the resolutions passed by directors at the end of the financial year were confirmatory of the interim payments preceding the date of the resolutions (rather than dispositive). It was also found that the trust deed did not expressly or impliedly provide for a duty to notify discretionary objects of their entitlement, nor did the relevant clause which provided for payment of income into a joint bank account require an acknowledgment of receipt of payment by or on behalf of the beneficiary, such that the trustee should be afforded full and final discharge of its obligations. Further, the Court of Appeal noted that the manner in which moneys in the joint bank account were subsequently used by a joint account holder did not provide a foundation for a duty of notification by the trustee. The case highlights the importance of interpreting the specific wording of the relevant terms of the trust deed.

Hancock v Rinehart

In the recent case of *Hancock v Rinehart* [2015] NSWSC 646, proceedings were brought by two beneficiaries of the Hope Margaret Hancock Trust (the trust) regarding the administration of the trust against a number of defendants, including the trustee of the trust, Mrs Georgina Rinehart. The court case was part of a long-running dispute between family members regarding the entitlements of the beneficiaries and allegations of breach of trustee duties. Mrs Rinehart had misrepresented to the beneficiaries that they would incur substantial capital gains tax unless the vesting date of the trust was extended. The plaintiffs sought removal and replacement of Mrs Rinehart as trustee of the trust on the ground of misconduct as she had demonstrated that she was unfit to retain the office of trustee.

Brereton J noted:

> *[47]*
>
> *… Mrs Rinehart having announced her intention to resign, there is no longer an issue in these proceedings whether she committed breaches of trust or misconducted herself so as to warrant her removal …*

The court ultimately appointed Mrs Rinehart's daughter, Bianca, as trustee of the trust in place of her mother. Brereton J weighed a number of factors when determining the appropriate trustee of the trust, including potential conflicts of interest or duties, the ability of a trustee to exercise its duties without influence or interference from others, and the expense of a professional trustee company. Brereton J indicated that an important consideration was the welfare of the beneficiaries of the trust.

The case also highlights the importance of trustees acting in good faith. In 2006, the constitution of Hancock Prospecting Pty Limited (HPPL) had been amended to include pre-emptive rights of existing members and to restrict the transfer of shares to non-family members, which had the effect of substantially limiting the "transferability and realisability" of shares in the company (*Hancock v Rinehart* [2015] NSWSC 646 at [53]). The assets of the trust mainly comprised shares in HPPL, which were said to be worth about $5b at the time of the hearing. Mrs Rinehart had resolved to amend the constitution of HPPL in her various capacities, including as trustee of the trust, as a director of two companies which also held shares in HPPL, and as a shareholder of HPPL in her personal capacity. It was contended by the plaintiffs that the consent given by Mrs Rinehart in her capacity as trustee of the trust was void as a fraud on her power as trustee:

> *[62]*
>
> *In essence, the plaintiffs' "fraud on a power case" was that Mrs Rinehart* qua *trustee consented to the 2006 Amendments not bona fide in the interests of the Trust, but for the purpose of conferring on herself directly or indirectly the ability to acquire the Trust's shares in HPPL in the event that she was removed and replaced as trustee and, more particularly … to deny the beneficiaries the ability to realise their beneficial interest for value.*

Brereton J held that it had not been established that Mrs Rinehart had acted for an improper or extraneous purpose in consenting to the amendments to the constitution of HPPL as it could be inferred that there were genuine reasons for the amendments to protect HPPL's interest in a joint venture arrangement, which Mrs Rinehart considered to be in the interests of the trust:

> *[94]*
>
> *… the circumstances that the effect of the 2006 Amendments is in at least some respects adverse to the beneficiaries and favourable to Mrs Rinehart's interests does not of itself mean that her decision to agree to them on behalf of the Trust was not a bona fide exercise of the power for proper purposes …*

An ancillary issue also considered by the court was the duty of the trustee to account. Brereton J noted at [339] a trustee's "fundamental obligation … to keep and render to the beneficiaries a full and candid record of their stewardship, including all appropriate financial accounts". Mrs Rinehart resisted an order to account on a number of bases, including a release by the beneficiaries, and the limitation period. An order was made upholding the plaintiffs' entitlement to inspect all trust documents.

Implications for trustees

The exercise of a trustee's discretion under a modern trust deed or sophisticated trust structure involving classes of beneficiaries and unitised and/or fixed interests to particular amounts of trust income or capital is not immune to challenge. Flexible trust deeds providing the trustee with complete uncontrolled and unfettered discretion in decision making may still be challenged where the discretion was not exercised by the trustees:

- in good faith;
- on real and genuine consideration; and
- in accordance with the purposes for which the discretion was conferred.

Chapter 2

General structuring guide

¶2-100 Introduction

The structures in chapters 3 and 4 of this guide illustrate various ways in which a business or investment can be structured. Each of the structures has different outcomes in respect of asset protection, flexibility of income distributions, tax treatment and other aspects of their operation.

So far as tax treatment is concerned, the key points guide for each structure details income tax and capital gains tax (CGT) issues relevant to the structure. In particular, the key points guides identify the availability of the discount capital gains and small business CGT concessions. These concessions can dramatically reduce the amount of tax payable on the sale of an asset.

The discount capital gains and small business CGT concessions are very complex in operation, particularly where a company or trust holds a business. When establishing a business, careful consideration should be given to the business structure and the ramifications of using a particular structure if there is a disposal of either the business or shares, or an interest in the structure that conducts a business. Failure to do this could result in the tax payable on a future disposal being significantly greater than it otherwise might have been.

The operation of the discount capital gains and small business CGT concessions should also be considered when a business is restructured. When an existing business is restructured, CGT liabilities may arise. Access to the small business CGT concessions may mean that the restructure could proceed without a CGT liability being incurred. The result of such a restructure is that the cost base of the assets restructured may be uplifted to the market value of those assets as at the date of the restructure with no corresponding CGT liability. Whenever only a part interest in a business is being disposed of, this potential uplift in cost base should be considered.

It is very important to consider the potential application of the discount capital gains and small business CGT concessions whenever a business or investment asset (or an interest in those assets) is to be disposed of to another party. Consideration of the issues should be undertaken *prior* to the relevant CGT event.

Finally, whenever a business is established or an investment asset is acquired, it is essential that the potential future application of the discount capital gains and small business CGT concessions be carefully analysed. As part of this process, once all structuring options have been considered, it will be imperative for the client to make the final decision on the type of structure to be adopted. In most instances particular structures will result in some form of compromise, whether that be in relation to asset protection, income tax or CGT. Therefore, it is important to realise that the information provided in this part of the guide outlines *recommended* structures only.

These recommendations are made primarily in relation to the asset protection, flexibility of income distributions, income tax and CGT issues relevant to each structure. Prior to any structure being adopted, all relevant facts should be considered.

Issues to be considered prior to a recommended structure being adopted for a particular situation are identified in the "Structuring checklist" in ¶2-105 of this guide.

The flowchart "Which structure is right for you?" in ¶2-110 of this guide assists in identifying potential structures which may be appropriate. The flowchart identifies those issues most commonly raised and refers to the more generally known structures. The flowchart does not address more specialised structures.

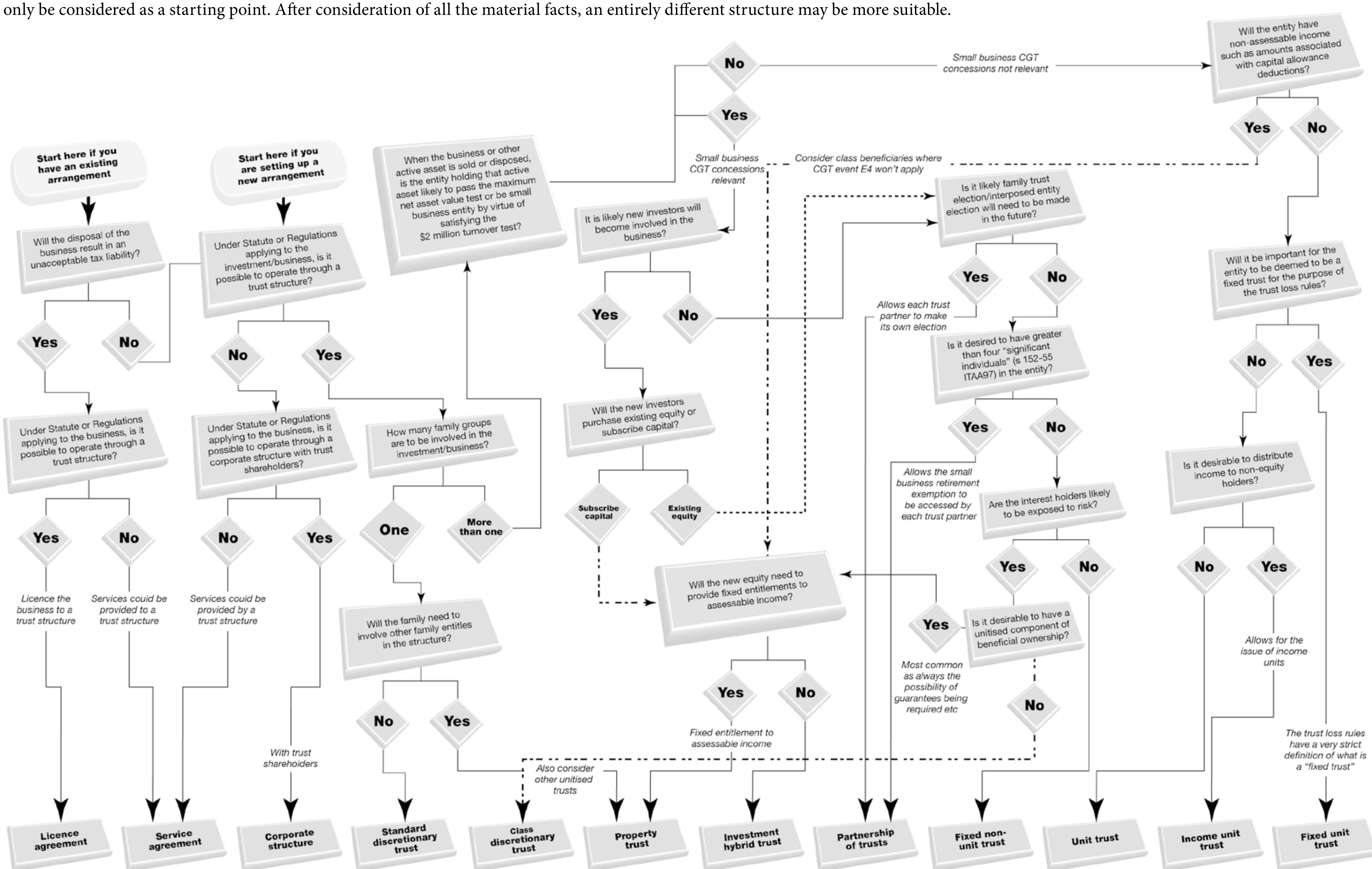
¶2-105 Structuring checklist

Have you considered:	Yes	No	N/A
■ the ability to isolate assets from risks such as:	❏	❏	❏
■ claims of creditors of a business;	❏	❏	❏
■ insolvent trading risks of directors and group companies;	❏	❏	❏
■ directors' liabilities in respect of both insolvent trading and tax;	❏	❏	❏
■ exposure to claims in relation to environmental issues, industrial matters, product liability or negligence;	❏	❏	❏
■ claims that are not sufficiently protected by insurance or where insurance liability is not admitted — for example, claims involving public risk and professional indemnity issues;	❏	❏	❏
■ exposure of assets to claims by spouses (including de facto spouses) following the failure of relationships and risks relating to court jurisdiction over disputed assets;	❏	❏	❏
■ cross liabilities through the provision of loans and guarantees;	❏	❏	❏
■ the ability to distribute the income of the structure amongst a wide range of beneficiaries;	❏	❏	❏
■ the establishment costs of the structure;	❏	❏	❏
■ the management and control of the structure;	❏	❏	❏
■ the administrative simplicity and cost efficiency of the structure;	❏	❏	❏
■ the regulatory requirements of operating a business through the structure;	❏	❏	❏
■ the ability to transfer interests between participants in the structure;	❏	❏	❏
■ the ability to introduce additional investors into the structure in the future;	❏	❏	❏
■ the ability to offer investment opportunities to the public at large (including how general *Corporations Act 2001* (Cth) issues and more specific managed investment scheme issues may be relevant);	❏	❏	❏
■ the implications in respect of both stamp duty and the goods and services tax relating to transactions both within and external to the structure, and any restructuring that may be necessary in the future;	❏	❏	❏
■ the ability to prepare the structure and costs, and implications of reorganising the structure to enable it to be listed on the Australian Stock Exchange;	❏	❏	❏
■ the CGT issues relevant to the structure, including issues relating to the disposal of assets by the structure and the disposal of interests in the structure;	❏	❏	❏
■ the applicable rate of tax payable by the entities involved in the structure;	❏	❏	❏
■ the payroll tax and WorkCover liabilities associated with a particular structure;	❏	❏	❏

■ the application of specific taxation rules such as the alienation of personal services income measures, the provisions of Div 7A ITAA36 which treat certain loans and payments as unfranked dividends and provisions dealing with the ability to offset income against losses (ie negative gearing);	❏	❏	❏
■ the ability to access various concessions available under the income tax legislation in addition to those relating to CGT, such as research and development concessions;	❏	❏	❏
■ the ability to pay superannuation contributions from the structure;	❏	❏	❏
■ the GST issues in respect of both registration for the tax system and also the timing of tax periods for the entities involved in the structure, their ability to group and their requirement to comply with the PAYG measures.	❏	❏	❏

¶2-110 Which structure is right for you?

This flowchart is merely a guide to illustrate some possible trust structures that may be appropriate in certain fact scenarios. It does not consider alternate structures such as companies, superannuation funds or joint ventures. The guide addresses (briefly) issues of capital gains tax, trust losses, requirements for family and interposed entity elections, the number of investors, regulatory restrictions, non-assessable income and the ability to access capital gains tax concessions. Although the flowchart may indicate that a particular trust structure is appropriate, this should only be considered as a starting point. After consideration of all the material facts, an entirely different structure may be more suitable.



¶2-115 Quick questions and answers

Assets can be held by a trust, a company or one or more individuals. As noted in this guide, the choice of how an asset will be held depends on many factors, including the business and personal circumstances of the individual. Below is a brief outline of issues for individuals to consider when contemplating the asset protection and taxation implications associated with assets other than the principal business and investment assets.

The general principle behind asset protection is that any assets which are not in your personal name or control and in respect of which you have no legal or equitable rights cannot be used to meet claims by creditors, trustees in bankruptcy or even spouses in family law property disputes. Accordingly, any assets that are not owned by you personally, but rather by separate legal entities such as companies, unit trusts, discretionary trusts and superannuation funds, may be protected from claims by third parties — provided appropriate control mechanisms are established. There are several important exclusions to this rule. However, a discussion of those issues is beyond the scope of this guide. *The existence of the exclusions illustrates the importance of obtaining professional advice in respect of specific fact scenarios.*

Asset protection mechanisms are often used to achieve one or both of the following objectives:

- isolating a particular asset(s) which may in the future be the subject of claims from assets held in other separate legal entities over which the “principal” has control; and
- protecting a particular asset(s) over which the principal has control from any potential claims made against the principal personally (eg as director of a company).

Who should own the family home?

It is suggested that the spouse who is not exposed to business risk should hold the family home.

For family law purposes, the family home is an asset of the marriage. Accordingly, although one spouse may have legal ownership of the family home, this will not hinder the other spouse from claiming a right to the family home because it is an asset of the marriage.

If the family home remains in the name of an individual (being the spouse not exposed to business risk) and the home is that person’s main residence then, on the disposal of the family home, no CGT is payable on the proceeds.

Who should hold personal assets such as insurance policies, holiday homes and investment properties?

It is recommended that consideration be given to holding certain personal assets in a discretionary trust because this may:

- minimise the risk of these assets being exposed to claims which may arise in the future because of:
  - the person's position as a director of a company;
  - the result of personal transactions such as the calling in of a loan;
  - the enforcement of payment of a personal guarantee given to a relative, friend, associated entity or other party; or
  - the breakdown of a marriage or of other domestic relationships;
- simplify intergenerational transfers of the assets.

Who should hold the holiday home?

It may be appropriate to hold the family holiday home in a discretionary trust.

The family holiday home will not be exempt from CGT on its disposal. If the family holiday home is in a discretionary trust, it may be isolated from business risks and, on its disposal, access to the general 50% CGT discount on any capital gain made on the sale may be available.

Alternatively, the family holiday home may be held in the name of the spouse who is not exposed to business risk. That spouse may also be able to treat the capital gain as a discount capital gain, and access the 50% CGT discount on any capital gain made on the disposal of the family holiday home.

What issues should be considered when arranging an insurance policy?

When an individual enters into an insurance policy, they need to ensure that the policy has flexible payment options (eg covering payment to a deceased estate, testamentary trusts, the policy-holder, surviving parents or children in their own right).

There are many other issues that should be considered in relation to insurance policies, such as the use of policies in business succession agreements (buy/sell agreements). Specific advice should be sought in these circumstances.

Who should hold investment properties?

Negative gearing an investment property requires careful planning. If such an asset is placed in a discretionary trust, the property owner will need to ensure that there is other income to offset the losses created by the negative gearing. This is a complicated area that requires considerable analysis of an individual's situation and advice specific to the proposed fact scenario should be sought.

Who should purchase the motor vehicle?

The purchase of a motor vehicle by either an individual or an entity involves the consideration of several issues, including fringe benefits tax, income tax and asset protection. Each case will need to be examined on its facts, and consideration needs to be given to the extent the motor vehicle is used for private and business purposes during the ownership period and the nature of the income derived by the vehicle's owner.

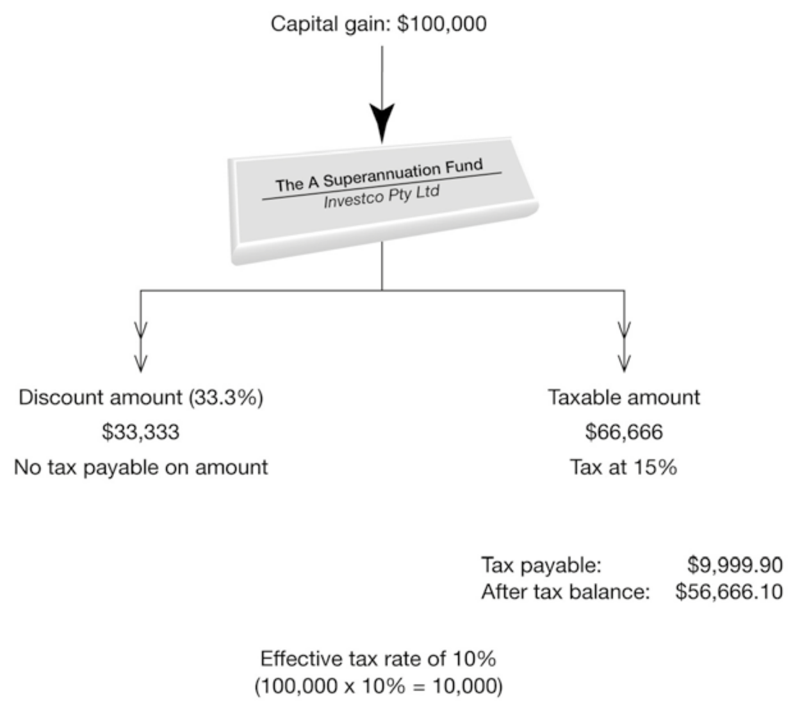
How should shares be held?

If the shares are public company listed shares held for the long term in order to obtain capital growth, either a superannuation fund or a discretionary trust can hold the shares.

A superannuation fund provides many benefits that are outlined below.

When the shares are disposed of by a discretionary trust, the discretionary trust may be able to treat any capital gain as a discount capital gain and access the 50% CGT discount on any capital gain made.

In respect of a superannuation fund, the CGT discount will be 33⅓%. However, in a superannuation fund, the resulting taxable capital gain will be taxed at 15% (effectively 10% on the total capital gain), whereas in a discretionary trust the taxable capital gain must be distributed to an individual and the amount is then taxed at marginal rates plus the Medicare levy. The marginal rate may be as high as 49% (effectively 24.5% on the total capital gain) or, in certain circumstances, even higher during periods of special levies.



How should I prepare my will?

An important aspect of succession planning, asset protection and tax planning is to have a testamentary trust in place. This trust is created by a will. Further detail of the operation and benefits associated with testamentary trusts are outlined in ¶3-160 of this guide.

The testamentary trust gives the primary beneficiaries of an estate the opportunity to:

- keep assets in a trust where they are protected from creditors because the creditor of a beneficiary cannot seize the assets of the testamentary trust to satisfy the debt;
- keep assets in a trust protected from family law property disputes;
- attempt to adjust the needs and expectations of a surviving spouse and surviving children; and
- distribute income to such members of the family as the trustee determines.

What is a superannuation fund and how should I use it?

A superannuation fund is a very effective investment vehicle. A regulated superannuation fund that complies with the *Superannuation Industry (Supervision) Act 1993* is only taxed at 15% on its taxable income — which will comprise all concessional contributions made by or on behalf of members, and all investment income, such as interest, rent and dividends net of all deductible expenses. Any capital gain made by the superannuation fund is discounted by one third if the asset is held for more than 12 months (ie it is taxed at rate of 10%). In addition, if a pension is being paid from the superannuation fund, it is not taxed on the income and capital growth of assets to which the pension(s) are attributable. Accordingly, a superannuation fund may quickly generate wealth from the reinvestment of after-tax income. Further, from 1 July 2007 benefits from a superannuation fund received by members aged 60 years or over are free from tax, whether received in a pension or as a lump sum.

The control of (and legal ownership of any asset held by) a superannuation fund rests with the trustee of the superannuation fund. The trustee can be individuals or companies. To better protect assets, it is recommended that a company (of which the members of the fund must be directors) act as trustee.

It is important to note that if a superannuation fund is a self-managed superannuation fund, restrictions apply as to: acquiring assets from related parties of the superannuation fund; the investments the fund may make; and any financing (borrowing and lending) that the trustee of the fund may propose to be involved in.

Members are prevented from accessing superannuation benefits until they qualify for a condition of release. There are a number of conditions of release. Some can be accessed automatically, such as reaching 65 years, starting a transition to retirement income stream on reaching the preservation age or death. Others may be accessed earlier if certain conditions are met, such as terminal illness, temporary or permanent incapacity, in cases of hardship or on compassionate grounds. The payment of a member's benefits is voluntary if a condition of release is met and is only compulsory on the death of a member.

On the death of a member, the trustees of a superannuation fund may only pay the deceased's benefits to the deceased's spouse, dependants, adult children or legal personal representative. The form of the benefits (pension or lump sum) and tax treatment (nil or up to 31.5%) will vary depending on to whom it is paid and what components the death benefit is made up of.

From 1 July 2007, there is no limit to the amount of concessionally held benefits a member can have in a superannuation fund, but the level of contributions that can be made to a fund is restricted. From 1 July 2007, the amount of concessional contributions that could be made to a superannuation fund was limited to $50,000 per annum (indexed) for each member. Effective from 1 July 2009, the restriction regarding the amount of concessional contributions that can be made to a superannuation fund was reduced to $25,000 per annum (indexed) for each member and subject to transitional rules.

From 1 July 2014, the concessional contributions cap increased to $30,000.

From 1 July 2015, the concessional contributions caps are:

- a general cap of $30,000; and
- for individuals aged 49 years or over on the last day of the previous financial year: $35,000 (a temporary increase on the general cap).

The temporary cap is not indexed, and will cease when the general cap is indexed to $35,000.

From 1 July 2015, as a result of the indexation of the concessional contributions cap, the cap for non-concessional contributions increased from $150,000 per annum per member to $180,000 per annum per member, provided the member is aged under 65 years. Non-concessional contributions can be brought forward for up to two years (eg $540,000 of non-concessional contributions could be made in the current financial year and no more non-concessional contributions could be made in the following two years).

When determining eligibility for a deduction on superannuation contributions, the "10% rule", governed by s 290-160 of the *Income Tax Assessment Act 1997* (Cth), is used. To claim a deduction, the sum of an individual's assessable income from employment, reportable fringe benefits total, and reportable employer superannuation contributions that can be attributed to those activities as employee must constitute *less than 10%* of the individual's total assessable income, reportable fringe benefits total, and reportable employer superannuation contributions.

For the purposes of the test under the 10% rule, all amounts attributable to an "employment" activity are taken into account, including:

- salary and wages;
- other payments, including commissions, remuneration of directors, and contract payments, that are considered to be "salary or wages" under s 11 of the *Superannuation Guarantee (Administration) Act 1992* (Cth). This provision covers payments that are made to persons who may not fit the common law definition of "employee" (for example, directors and contractors);
- employment termination payments; and
- payments for workers compensation payments received as a result of an injury suffered while engaging in an employment activity, and where the payments are received while holding the employment, office or appointment the performance of which gave rise to the entitlement to the compensation payments (TR 2010/1).

Trustees of superannuation funds should also keep in mind the recent decision of *Australasian Annuities Pty Ltd (in liq) v Rowley Super Fund Pty Ltd* [2015] VSCA 9. In that case, a corporate trustee of a discretionary trust borrowed money to make employer superannuation contributions, pay eligible termination payments, and make loans to beneficiaries which amounts were in turn used to make further superannuation contributions. The director of the corporate trustee was held to have breached his fiduciary duties as he sought to benefit himself and his family in the course of these transactions and, in so doing, he failed to consider the other beneficiaries of the trust. This ultimately allowed creditors to claw back all of the contributions made to the superannuation fund. Directors of corporate trustees should consider documenting in their resolutions that they have considered the interests of all of the beneficiaries when related-party transactions are undertaken.

¶2-120 Asset protection consequences of "trust busting"

The traditional use of trusts as an effective asset protection mechanism has been challenged in recent years. A number of court decisions in the context of family law property settlements and receivers' orders have led to some practitioners questioning the role of trusts in the wealth preservation strategy of successful families.

This paragraph critically considers these issues in relation to discretionary trusts (also referred to as family trusts).

"Trust busting" in recent years

As discussed in ¶3-100 of this guide, a discretionary trust generally has two classes of beneficiaries — primary or specified beneficiaries, who are often the takers in default in relation to undistributed trust income; and general beneficiaries, who usually consist of a wide range of individuals, companies and trusts.

The interest of a beneficiary in the trust property is not a proprietary interest, or a mere expectancy in a proprietary interest or a contingent interest, as regardless whether a trustee is required by the trust deed to fully distribute the trust's income (depending on whether the trustee's power of appointment is a trust power of mere power), a particular member of a class of beneficiaries may not receive any appointment of income.

Consequently, trusts have been a key feature in asset protection strategies.

However, in recent years the Family Court has adopted a "trust busting" approach, treating trust property as property of the parties to the marriage (parties) or either of them (party) and making property settlement orders accordingly.

The Federal Court previously adopted a similar approach to the Family Court when assessing receivers' orders in *Australian Securities and Investments Commission; In the matter of Richstar Enterprises Pty Ltd v Carey (No. 6)* [2006] FCA 814 (*Richstar*).

Who has an interest in the trust fund of a discretionary trust?

Trustee

The word "interest" in the strict legal sense can be either vested (the right does not depend on whether or not some event occurs) or contingent (the right depends on whether or not some event occurs).

Often the trustee of a discretionary trust is excluded from being a beneficiary and the potential beneficiaries of the trust are restricted to a particular class — for example, the members of a particular family group. The trustee, as the legal owner and registered proprietor of the assets of the trust fund, has a legal, but no beneficial interest in the assets of the trust fund (except to the extent of any right of indemnity out of the trust assets). In these circumstances, the trustee will not have a general power of appointment, but a special or hybrid power that does not bring with it "de facto ownership".

In contrast, a trustee who has a general power of appointment exercisable in favour of any person, including themselves, is in the position to appoint the whole of the trust property for their own use and benefit absolutely, and is therefore considered as being for all intents and purposes, the legal and beneficial owner of the trust property.

Beneficiaries

Of the two classes of discretionary trust beneficiaries discussed above, general beneficiaries (also referred to as "mere objects") have no rights in the trust other than the right to its due administration.

Primary, or default, beneficiaries are usually included in the class of general beneficiaries but have the additional right to any of the income or capital of the trust which has not been the subject of an effective accumulation or appointment by the trustee during the term of the trust. Such beneficiaries have vested but defeasible interests in the subject matter of the trust — interests which can be defeated or taken away at any time prior to the vesting or termination of the trust and accordingly are "vested" in interest but not in possession.

None of the rights of general beneficiaries (or mere objects) and primary beneficiaries (or takers in default) give any of the beneficiaries a vested interest in possession of the trust or in any assets of the trust until either the trustee makes a specific appointment in favour of any of those beneficiaries or, in the case of the primary or default beneficiaries, the trust vests and on that event there are assets of that trust which have not been the subject of an effective prior appointment.

Clarification of the nature of a discretionary beneficiary's interest under a discretionary trust and confirmation of the above analysis was recently provided by Redlich JA in the Victorian Court of Appeal decision of *Lygon Nominees Pty Ltd v Commissioner of State Revenue* [2007] VSCA 140. After considering the decision of the trial judge, an analysis of case law and commentary in leading texts, Redlich JA stated:

> *77. ... The nature of a discretionary beneficiary's interest under a discretionary trust as a consequence of the objects' rights to have the trust properly administered, does not confer the required proprietary interest. The right of an object to take legal proceedings to prevent a disposal of income or capital by the trustee to persons outside the class of designated objects does not involve the assertion of a proprietary right by the object. While the objects of the power are able to enforce the fiduciary duties of the donee of such a power, the objects will acquire no direct interest in the property which is subject to the power until such time as the power may be exercised in their favour. Until the trustee elects to exercise the power of appointment in the object's favour, the interest of the object is no more than an expectancy to receive income or capital as a result of the exercise of the power by the trustee and is analogous to that of a beneficiary in the residue of an unadministered estate. While the discretionary beneficiary may enforce the terms of the trust, the beneficiary does not*

have an equitable proprietary interest in the trust assets which constitutes beneficial ownership of any of those trust assets.

78. *The interest is a mere expectancy with neither "an interest in possession" — namely a present right of present enjoyment of property — nor an immediate entitlement to income as it accrues. The interest does not create or confer an interest in the property or a right of enjoyment and does not constitute any form of ownership. It is not a rateable interest as it does not bear the "necessary quality of definable extent which must exist before it can be taxed." (Gartside v IRC [1968] AC 553 at 602-3 (Lord Reid)). The interest has in this sense been viewed as insufficient under other revenue statutes because a right to present enjoyment of corpus and income is absent.*

The Family Court's approach

The process for making family law orders is discussed in ¶2-125 of this guide.

The Family Court is empowered to make property orders primarily pursuant to ss 79(1)(a), 90AE(2), 106B of the *Family Law Act 1975* (Cth) (FLA).

Altering the interests of the parties — s 79(1)(a) FLA

Section 79(1)(a) FLA empowers the Family Court to make various orders altering the interests of the parties in property settlement proceedings:

79(1) In property settlement proceedings, the court may make such order as it considers appropriate:

(a) in the case of proceedings with respect to the property of the parties to the marriage or either of them — altering the interests of the parties to the marriage in the property; or

…

including:

(b) an order for a settlement of property in substitution for any interest in the property; and

(c) an order requiring:

(i) either or both of the parties to the marriage; or

…

to make, for the benefit of either or both of the parties to the marriage or a child of the marriage, such settlement or transfer of property as the court determines.

79(2) The court shall not make an order under this section unless it is satisfied that, in all the circumstances, it is just and equitable to make the order …

In *Kennon v Spry* [2008] HCA 56 (*Spry*), Gummow and Hayne JJ observed, at [128], that the reference in s 79 to "the parties to the marriage or either of them" includes a reference to the parties to a marriage terminated by divorce at a time before the court makes its order.

In *Spry*, French CJ made the following observations:

64. *The word "property" in s 79 is to be read as part of the collocation "property of the parties to the marriage". It is to be read widely and conformably with the purposes of the Family Law Act. In the case of a non-exhaustive discretionary trust with an open class of beneficiaries, there is no*

obligation to apply the assets or income of the trust to anyone. Their application may serve a wide range of purposes. In the present case, prior to the 1998 instrument those purposes could have included the maintenance or enrichment of [the Wife].

65. *Where property is held under such a trust by a party to a marriage and the property has been acquired by or through the efforts of that party or his or her spouse, whether before or during the marriage, it does not, in my opinion, necessarily lose its character as "property of the parties to the marriage" because the party has declared a trust of which he or she is trustee and can, under the terms of that trust, give the property away to other family or extended family members at his or her discretion.*

66. *For so long as [the Husband] retained the legal title to the Trust fund coupled with the power to appoint the whole of the fund to his wife and her equitable right, it remained, in my opinion, property of the parties to the marriage for the purposes of the power conferred on the Family Court by s 79. The assets would have been unarguably property of the marriage absent subjection to the Trust.*

67. *An exercise of the power under s 79 requiring the application of the assets of the Trust in whole or in part in favour of [the Wife] would, prior to the 1998 Instrument, have been consistent with the proper exercise of [the Husband]'s powers as trustee and would have involved no breach by him of his duty to the other beneficiaries.*

Setting aside transactions — s 106B FLA

Section 106B FLA empowers the Family Court to set aside transactions which would have the effect of defeating claims under the FLA:

106B Transactions to defeat claims

(1) *In proceedings under this Act, the* ***court may set aside*** *or restrain the making of* ***an instrument or disposition*** *by or on behalf of, or by direction or in the interest of, a party,* ***which is made or proposed to be made to defeat an existing or anticipated order*** *in those proceedings or which, irrespective of intention, is likely to defeat any such order.*

…

(3) *The court must have regard to the interests of, and shall make any order proper for the protection of, a bona fide purchaser or other person interested …* (emphasis added)

The s 106B powers would be exercised by the Family Court where, for example, a party has deliberately attempted to undermine the powers of the Family Court, for example, by removing the control that that party exerts over the trust, effecting a change of trustee, removing beneficiaries or distributing trust assets to other beneficiaries.

In *Kennon v Spry* [2008] HCA 56 (*Spry*), the High Court upheld the Family Court's orders pursuant to s 106B FLA to set aside instruments that effectively disposed of Mrs Spry's equitable right to be considered in the application of the trust fund, and which also disposed of trust assets to the children's trusts.

Property of third parties — s 90AE(2) FLA

The Family Court is empowered under s 90AE FLA (which is contained in Pt VIIIAA FLA) to alter the ownership of the property of a third party and direct that third party to transfer property to a party:

> *90AE(2) [Other orders court may make]*
>
> *In proceedings under section 79, the court may make any other order that:*
>
> *(a) directs a third party to do a thing in relation to the property of a party to the marriage; or*
>
> *(b) alters the rights, liabilities or property interests of a third party in relation to the marriage.*

In *B Pty Ltd & Ors and K & Anor* [2008] FamCAFC 113, the Full Court of the Family Court emphasised that all that s 90AE(2)(b) does is enable the court to adjust the property interests of a third party for the purpose of effecting a division of the property of the parties between those parties.

"Property of" a party to a marriage

Both ss 79(1)(a) and 90AE(2)(b) FLA refer to "property of a party to the marriage".

"Property" is defined in s 4(1) FLA:

> *property means:*
>
> *(a) in relation to the parties to a marriage or either of them—means property to which those parties are, or that party is, as the case may be, entitled, whether in possession or reversion; or …*

Property in a legal sense does not mean the same as "property" in that word's ordinary usage. Whereas most people will think of property as being the tangible objects that one can own, such as land, motor vehicles and personal effects, in the legal sense property means the rights that a person (usually the owner) has in relation to those tangible items. As it is the rights rather than the objects that constitute "property" in a legal sense, it is possible for rights in relation to intangible matters to be property in themselves. For example, a person who is owed money by another person has a right to sue the other person for payment of the debt, and this right (called a "chose in action" or sometimes now called a "thing in action") is a form of property.

When determining what constitutes the "property of" the parties to the marriage or either of them, the Family Court must first consider whether it is just and equitable to make the order (pursuant to s 79(2) FLA). The following questions, which reflect the factors to consider set out in s 79(4) FLA, can then be posed to determine the nature of the order (*Stanford v Stanford* [2012] HCA 52):

(1) What were the assets, liabilities and financial resources of the parties and their values at the time of the hearing?

(2) What were the financial and non-financial contributions made directly or indirectly by or on behalf of each party to the acquisition, conservation or improvement of the property?

(3) What was the contribution made by each party to the welfare of the family including contributions made in the capacity of homemaker or parent?

(4) What is the effect, if any, of any proposed order on the earning capacity of each party?

(5) What matters referred to in s 75(2) FLA are relevant and what adjustment, if any, should be made as a result of these factors? (Such factors include the parties' age, state of health, income, property and financial resources, financial commitments, child custody arrangements, standard of living, maintenance payments, arrangements for payment of creditors and receipts of pensions, allowances and benefits.)

(6) Have there been any other orders made affecting a child or either party and is child support payable or likely to be payable in the future for the children of the marriage?

(7) After consideration of these matters, is it just and equitable to make the actual orders?

The Family Court's approach is motivated by the need to resolve property settlements in an equitable manner between the parties.

In *Simmons & Anor v Simmons* [2008] FamCA 1088 (*Simmons*), Watt J stated at [115]:

> *The Full Court has previously emphasised the need to determine issues such as those raised in the current proceeding in light of contemporary trends.*

His Honour referred to *In the Marriage of Davidson (No. 2)* (1990) 101 FLR 373, where the Full Court observed at 382:

> *Whatever may have been the position one hundred years ago, Australian courts today have to look at the reality of the situation and the purpose which family trusts serve today.*

In *Spry,* French CJ considered, whether the parties had prior to the 1998 instrument, interests in or in relation to the assets of the trust that could answer the description of "property of the parties to the marriage". He made the following observations:

> *77. The beneficiary of a non-exhaustive discretionary trust who does not control the trustee directly or indirectly has a right to due consideration and to due administration of the trust but it is difficult to value those rights when the beneficiary has no present entitlement and may never have any entitlement to any part of the income or capital of the trust.*
>
> *78. Gummow and Hayne JJ, in their joint reasons, characterise [the Wife]'s right with respect to the due administration of the Trust as part of her property for the purposes of the Family Law Act. I respectfully agree with their Honours that prior to the 1998 Instrument the equitable right to due administration of the Trust fund could be taken into account as part of the property of [the Wife] as a party to the marriage. So too could her equitable entitlement to due consideration in relation to the application of the income and capital. In so agreeing, however, I acknowledge, consistently with the observations of the Full Court in Hauff and Evans, that it is difficult to put a value on either of these rights though a valuation might not be beyond the actuarial arts in relation to the right to due consideration.*
>
> *79. [The Husband]'s power as trustee to apply assets or income of the Trust to [the Wife] prior to the 1998 Instrument was, as pointed out by Gummow and Hayne JJ, able to be treated for the purposes of the Family Law Act as a species of property held by him as a party to the marriage, albeit subject to the fiduciary duty to consider all beneficiaries. This is so even though it may not be property according to the general law. So characterised for the purposes of the Family Law Act it had an attribute in common with the legal estate he had in the assets as trustee. He could not apply them for his own benefit but that did not take them out of the realm of property of a party to the marriage for the purposes of s 79. Insofar as Gummow and Hayne JJ rely upon the property comprised by*

[the Husband]'s power as trustee and [the Wife]'s equitable rights prior to 1998, I agree that these property rights were capable of providing a basis for the orders which Strickland J made. I do so, as already indicated, by considering that power and the equitable rights, in conjunction with [the Husband]'s legal title to the Trust assets, without which the power and the rights were meaningless.

80. [The Wife]'s right to due consideration as an object of the Trust could also be taken into account in determining whether it was just and equitable to make an order under s 79 on the basis that the assets of the Trust were property of the marriage. As noted in the preceding section the equitable entitlement of the children and other existing beneficiaries to due consideration could also be taken into account in making that judgment …

81. The assets of the Trust, coupled with [the Husband]'s power to appoint them to his wife and her right to due consideration, were, until the 1998 Instrument, the property of the parties to the marriage for the purposes of s 79. The fact that [the Husband] removed himself as a beneficiary by the 1983 Deed does not affect that conclusion. Because the 1998 Instrument effectively disposed of [the Wife]'s equitable right to be considered in the application of the Trust fund, and having regard to the trial judge's conclusions about the purpose of the instrument, the order setting it aside was an appropriate exercise of the Family Court's power under s 106B. [The Wife]'s equitable right could then be considered as part of the property of the parties to the marriage …

Stephens and Stephens & Anor (Enforcement) [2009] FamCAFC 240 (*Stephens*) concerned an appeal in enforcing the Family Court orders following the High Court's decision in *Spry*. Dr Spry had an obligation to pay the wife $2.182m and contended that the maximum that could be paid was $1.790m, being the value of *his* net assets. Mrs Spry contended that her entitlement could be satisfied from the assets of the family trust. The Full Court (May, Boland and O'Ryan JJ) in upholding Coleman J's orders attaching to assets of the trust, stated:

348. We accept that the approach taken by Strickland J and the majority of the Full Court, albeit by different routes, was to treat the assets of the Trust as the property of the Husband. For reasons we need not repeat this was not accepted by the High Court. However what French CJ and Gummow and Hayne JJ considered was whether in the circumstances there was "property of the parties to the marriage or either of them".

349. Without repeating what their Honours said, in our view, in the circumstances of this case, for the purposes of determining the respective entitlements of each party after consideration of the matters in s 79(4) of the Act, the trial Judge had the jurisdiction to include the assets of the Trust in the "pool of assets" which also included the individual property interests of each party.

350. The trial Judge also had the power to make an order that took into account the inclusion of the assets of the Trust. In circumstances such as in this case, an order may be made for the payment of an amount on the basis that the assets of the trust are within the disposition of the party to the marriage who has power to appoint the assets of the trust, even if at the date when the property settlement power is exhausted the other party to the marriage by reason of a divorce no longer remains within the class of objects. Thus, the trial Judge could make an order that granted to one party an entitlement that exceeded the net individual property interests of the parties. There is no controversy about this.

351. However, the issue then arises as to the implementation of such an order if it becomes necessary either as part of the s 79 order or as in this case subsequent enforcement proceedings. In other words, as in this case, what should happen if it is necessary for the assets of the Trust to be attached to satisfy the property settlement entitlement of a party?

> *352. French CJ was of the view that in the circumstances of this case in the event that it was necessary to make an order attaching to the assets of the Trust for the purposes of satisfying the entitlements determined by the trial Judge, this could be part of the s 79 order. Thus, in any subsequent enforcement proceedings there are no issues about consideration of the interests of other objects of the Trust.*
>
> *353. However, Gummow and Hayne JJ were of the view that if the third party assets were of a discretionary trust then it may be necessary to make an application of the type that they outlined at [138] and if necessary at [139] either as part of the s 79 proceedings or in any subsequent enforcement proceedings.*
>
> *354. In this regard we observe that although in the circumstances of this case Pt VIIIAA of the Act was rejected by Strickland J, all parties agreed that there was jurisdiction under that Part to make an order against assets of the Trust. In our view, this is correct and that it may be applied in circumstances where an order is sought that an entitlement under a property settlement order be satisfied out of the assets of a trust.*
>
> *355. In our view, it follows that an order may be made that enables an entitlement of a party to the marriage who is an object of a trust, or ceased to be an object by reason of divorce, to be satisfied out of the assets of the trust. Put another way, an order may be made that enables a party to the marriage who is in control of the trust to satisfy his or her personal liability to the other party to the marriage who is an object of the trust from the assets of the trust.*
>
> *356. In our view, what happened was clearly in accordance with what Gummow and Hayne JJ said at [138] to [139].*
>
> *357. It follows that we are of the view that in the circumstances it was within jurisdiction and power for Coleman J to make orders that attached to assets of the Trust*
>
> …
>
> *361. In the event that the assets of the Trust are to be used for the purpose of satisfying an entitlement pursuant to the property settlement order, Gummow and Hayne JJ said at [138], that before making such an order the court would have, "regard to the interests of any third parties who may also fall within the defined class of 'beneficiaries'". If such third parties are children of the marriage and, as French CJ said at [70] that the "origins of [the] greater part" of the assets of the trust were contributions made by the parties to the marriage during the marriage, then the interests of the children may be put aside. However, where persons other than the parties to the marriage and the children of the marriage are discretionary objects, such third parties would have standing to oppose the order and as Gummow and Hayne JJ said at [138], "[i]t would be for the court to determine whether ... it was just and equitable to make the order having regard to the interests" of such third parties ...*

In *Stanford v Stanford* [2012] HCA 52, the High Court emphasised that the Family Court cannot override trust law principles when making orders in respect of matrimonial property settlements. The court reiterated the principle articulated by the majority in the decision of *R v Watson; ex parte Armstrong* [1976] HCA 39 in relation to maintenance and property settlement orders:

> *The judge called upon to decide proceedings of that kind is not entitled to do what has been described as "palm tree justice". No doubt he is given a wide discretion, but he must exercise it in accordance with legal principles, including the principles which the Act itself lays down.*

Further, the court confirmed that, when considering whether an order would be just and equitable, the existing legal and equitable interests of the parties to the property must be identified. The *Stanford* case involved an elderly couple involuntarily separated due to the ill health of the wife who required nursing home care and died during the course of proceedings. The husband had set up a trust fund for his wife's benefit while she was alive. The High Court upheld the husband's appeal against a property settlement order for a payment to the wife's estate, initiated by the legal personal representative of the wife's estate, as it would not have been just and equitable to make such orders.

Consequently, it now seems that *Spry* did not overturn basic trust principles — the power of the Family Court is not to be exercised by reference to any "unguided judicial discretion"[1] or sense of "moral obligations".[2] Instead, the Family Court must decide whether it is just and equitable to make an order having regard to the same legal titles and equitable principles governing the rights of any two persons who are not spouses.

Connection between the party and the trust

The Family Court treats the assets of a family trust as the property of the parties or either of them, where the court can establish a connection between the trust and the relevant party.

The court has found a connection to exist where a party is the appointor or controller of the relevant trust, trust property consists of assets accrued during the marriage from the efforts of one or both parties, and the parties are able to directly or indirectly benefit from the trust. These factors are considered below.

Control over the trust

A trust is controlled by its trustee and appointor — the trustee managing the day-to-day operations of the trust and the appointor having the ability to remove the trustee. If the trustee is a company, it is necessary to review the identity of its directors and shareholders (commonly either or both the husband and wife).

The element of control was a decisive factor in the following decisions:

- In *In the Marriage of Ashton* (1986) 11 Fam LR 457, the husband replaced himself as trustee with a corporate trustee and was sole appointor. He received trust income although he was not a beneficiary of the Trust. He was deemed to be "in full control of the assets of the trust" as he applied the assets and income from them as he wished and for his own benefit (at 461).
- In *In the Marriage of Goodwin* (1990) 14 Fam LR 801, the husband was the sole appointor and was a beneficiary to whom the trustee could make payments exclusively.

Although the High Court in *Ascot Investments Pty Ltd v Harper* [1981] HCA 1 accepted the submission of the appellant company that as a consequence of restrictions imposed by the memorandum and articles of association of the company, the husband could not compel the registration of the transfer of his shareholding to the wife and the appellant and its directors could not be ordered to register the transfer of shares, Gibbs J made the following observation:

1 *Stanford v Stanford* [2012] HCA 52 at 38.

2 Ibid at 48.

20. *The position is, I think, different if the alleged rights, powers or privileges of the third party are only a sham and have been brought into being, in appearance rather than reality, as a device to assist one party to evade his or her obligations under the Act. Sham transactions may always be disregarded.* ***Similarly, if a company is completely controlled by one party to a marriage, so that in reality an order against the company is an order against the party, the fact that in form the order appears to affect the rights of the company may not necessarily invalidate it.***

21. *Except in the case of shams, and companies that are mere puppets of a party to the marriage, the Family Court must take the property of a party to the marriage as it finds it. The Family Court cannot ignore the interests of third parties in the property, nor the existence of conditions or covenants that limit the rights of the party who owns it. To take two obvious examples, the Family Court could not compel a husband to assign to his wife a lease without obtaining the necessary consent of the lessor, and could not order the transfer to a wife of land owned by a husband free of mortgage, when in fact the land was mortgaged to a third party. Thus, in the present case, the Court must deal with the husband's shares in Ascot Investments as they in fact are, that is, as shares in a company whose memorandum and articles contain a restriction on transfer.* (emphasis added)

Accumulation of trust assets during the marriage

The accumulation of trust assets during the course of a marriage from the efforts of one or both parties and their ability to benefit from the trust was a key factor in the recent High Court decision of *Spry*, where French CJ stated:

[64] *The word "property" in s 79 is to be read as part of the collocation "property of the parties to the marriage". It is to be read widely and conformably with the purposes of the Family Law Act. In the case of a non-exhaustive discretionary trust with an open class of beneficiaries, there is no obligation to apply the assets or income of the trust to anyone. Their application may serve a wide range of purposes. In the present case, prior to the 1998 instrument those purposes could have included the maintenance or enrichment of [the Wife].*

[65] *Where property is held under a non-exhaustive discretionary trust with an open class of beneficiaries by a party to a marriage and the property has been acquired by or through the efforts of that party or his or her spouse, whether before or during the marriage, it does not, in my opinion, necessarily lose its character as "property of the parties to the marriage" because the party has declared a trust of which he or she is trustee and can, under the terms of that trust, give the property away to other family or extended family members at his or her discretion.*

…

[70] *The characterisation of the assets of the trust, coupled with [the Husband's] power to appoint them to his wife and her equitable right to due consideration, as property of the parties to the marriage is supported by particular factors. It is supported by his legal title to the assets, the origins of their greater part as property acquired during the marriage, the absence of any equitable interest in them in any other party, the absence of any obligation on his part to apply all or any of the assets to any beneficiary and the contingent character of the interests of those who might be entitled to take upon a default distribution at the distribution date.*

In this case, Keifel J stated that "property" is to be read as including those assets to which the parties have contributed throughout the course of their marriage and which are held for their use and benefit and found that the trust's assets constituted property, much of which was obtained by way of the parties' contributions to the marriage:

> *[225] … "Property" is to be read as including those assets to which the parties have contributed throughout the course of their marriage and which are held for their use and benefit. The trust assets constitute property, much of which was obtained by way of the parties' contributions to the marriage … Further, as shall become clear, on each occasion that property was transferred to the trust, the parties "dealt with" their property … The trust property represents contributions of the parties and is held on terms of a settlement. It is "property dealt with by … settlements".*

Keifel J also noted at [215] in *Spry* that property accumulated or settled on trust "before" the commencement of a marriage may be subject to an order of the Family Court under s 85A FLA if it can be determined that the settlor had the particular marriage between the two parties to the future marriage in mind when settling the trust, as opposed to any future marriage by one of the parties.

Potential to benefit from trust assets

The use of trust assets for the benefit of one or both of the parties was also a factor in *In the Marriage of Goodwin* (1990) 14 Fam LR 801 discussed above.

The recent decision of the Full Court of the Family Court in *Essex v Essex* [2009] FamCAFC 236 (*Essex*) illustrates that the possibility of benefitting from a trust, even in the absence of receiving actual distributions, may suffice to include a trust's assets as part of the financial resources of a party. This case concerned an appeal by the wife seeking orders that the assets be divided 70%:30% in her favour and that the assets of two family trusts (the N Trust and the s Trust) be treated as a financial resource of the husband's. The trust funds were constituted by gifts from the husband's parents and established to provide for the husband's mother's living expenses after the parties separated. The husband had not received any distributions from either trust and only managed the day-to-day affairs of the corporate trustee of one of the trusts in his brother's absence.

The Family Court found that it was possible but unlikely that income from the N Trust would be available for distribution to the husband and the wife as the trusts were primarily set up to provide the capital for the benefit of the parties' children; and that it was unlikely that either party would receive any capital from the s Trust, that neither party had a legal or equitable right to the s Trust's capital or income, and that the inclusion of the husband as a general beneficiary did not give the husband any interest in the property contained within the trust and that the trusts did not constitute a financial resource of the husband (at [99]-[101]).

On appeal to the Full Court, Bryant CJ and Boland J stated (at [168]-[174]):

> *168. We discern no error by the trial Judge in his careful discussion of the terms of the trust deed. We consider his Honour was clearly correct in his finding that the assets of the s Trust were not the property of the husband. But was his Honour correct in his assessment of the husband's brother's evidence, together with all the other evidence, in determining the husband did not have a financial resource in this trust? We think not.*
>
> …

> 172. *We consider there is merit in the submissions of the wife's counsel insofar as the s Trust is concerned, and that the evidence admits a compelling inference that the husband will receive distributions from the s Trust at the conclusion of the proceedings:*
>
> - *First, if the purpose of the settling of the trusts was to entitle the husband's mother to receive an aged pension in due course, and to prevent her making imprudent investment decisions, that could have been achieved by the settling of one trust, the settling of the N Trust was unnecessary.*
> - *Second, the difference in the provisions of the two trust deeds is relevant. The beneficiaries named in the N Trust deed evince a clear intention in the drafting of that trust to benefit the husband's brother and his wife. As they do not have children, the wide class of general beneficiaries (who are not named) is readily appreciable. The s Trust deed evinces a clear intention that the capital of that trust be distributed on vesting, or at such earlier time as the trustee may determine, to the two children of the marriage, the grandchildren of the husband's mother.* ***It also discloses a clear intent that the husband, as one of the three named income beneficiaries, is entitled to be considered to receive distributions of income until the vesting of the trust****.*
> - *Third, the husband had the effective day to day operation of the trusts for a period of approximately 18 months and was well aware of the assets of the trusts. The husband's brother only retrieved relevant trust documents from the husband some months prior to the hearing.*
> - *Fourth, Mr RO's contemporaneous file note of the purpose of the settling of the trust is compelling. Although the husband's brother said in his cross-examination that Mr RO's email was incorrect, it is not inconsistent with the husband's brother's own affidavit (see paragraph 100 of these reasons) and his oral evidence set out in paragraph 108 of these reasons.* ***The husband's brother's answers did not demonstrate that the husband would never receive income, or even that he was unlikely to receive income from the trusts.*** *Rather, his answers in cross-examination strongly implied that the restrictions on the husband's receipt of income were dictated by the proceedings, and particularly if his actions as controller of W Pty Ltd might be seen to directly or indirectly or benefit the wife.*
>
> ...
>
> 173. *It is also of significance that when the husband's brother chose to borrow approximately $135,000.00 from trust assets he did so from the assets of the N Trust. This action implies the assets of s Trust were to remain intact for the income and capital beneficiaries of that trust.*
>
> 174. *Significantly, as the sole director of the corporate trustee of the S Trust the husband's brother had control of that trust and was only obliged to consider the husband as one of the three income beneficiaries entitled to the income of the trust. However, the husband's brother conceded that, but for a disqualifying factor (the property proceedings) the husband should have the benefit of assets in the trusts. This in our view required the trial Judge to find that the s Trust was a financial resource of the husband.* (emphasis added)

As a consequence of these decisions, it would seem that very few family trusts would be protected from the reach of the Family Court.

Lack of connection between trust and the party

The trust property will not be treated as the property of the parties or one of them where there is no connection between the trust and the relevant party.

Such situations include where a party is not the settlor, appointor or beneficiary and cannot assert any legal or equitable right in respect of the trust property (*In the Marriage of Kelly (No. 2)* (1981) 7 Fam LR 762).

A lack of connection was also relevant in the context of third party property rights in the case of *B Pty Ltd & Ors and K & Anor* [2008] FamCAFC 113 where the Full Court found that there was no nexus between the husband's chose in action as a beneficiary and the trust assets which gave the husband any proprietary interest in those assets.

Trusts established by parents of a party

If the Family Court's emphasis is on assets accumulated by the trust *during the course of* a marriage (*Spry* [2008] HCA 56 at 274) there is scope for arguing that a trust's property is not that of the parties where the trust was established by the parents of one party and its assets accumulated prior to the marriage.

However, the decisions in *Simmons & Anor v Simmons* [2008] FamCA 1088 (*Simmons*) and *Coventry v Coventry and Smith* [2004] FamCA 249 (Coventry) have challenged this notion in situations where there is a connection between the trust's assets and a party and where the element of control is present or, as in the case of *Milankov and Milankov* [2002] FamCA 195 (*Milankov*), will be present in the future.

Further, where the requisite degree of control is present, property held under trust by a party that has been acquired before a marriage would also be included within the ambit of "property of" the parties following French CJ's judgment in *Spry* (at 274).

Simmons concerned an application by the trustee company for summary dismissal of the wife's amended application for final orders under Pt VIIIAA FLA. The trust was established by the husband's father and the beneficiaries included the husband's mother, the husband and his siblings, their spouses and their children. The husband was not a director of the trustee company or an appointor. The court considered whether the husband's interest as an object of the trust was property for the purposes of s 79 FLA. Watt J observed (at [119]-[121]) that there was a connection between the trust's assets and the husband as although the genesis of the trust's assets could be attributed to the husband's father, the original corporate structure included the husband as a substantial shareholder and his shareholding had been converted into interest free loans to the trust that did not require repayment until 35 years after they were advanced, thus representing a significant investment in the trust by the husband. Accordingly, there was a sufficient nexus between the assets of the trust and the property of the parties to the marriage for a court to find that Pt VIIIAA applied and was available to enable orders binding third parties to be made (at [123]).

In *Coventry*, the trust was established by the husband's father for the benefit of the husband and his family (including the wife). The husband's mother was sole trustee following the father's death. Although the husband had received no trust distributions, the assets of the trust were included in the property settlement as the husband was perceived to control the assets of the trust by virtue of his position as appointor.

In *Milankov*, the court found that, while the husband did not at the time of the hearing control the trust established by his father, under the terms of the trust, he would control all of the trust's assets following his father's death and would therefore have the ability to distribute the assets to himself.

Receivers' orders

In *Richstar*, the Federal Court adopted a similar approach to that of the Family Court.

In this case, ASIC sought to amend the receiver orders it had obtained under s 1323 of the *Corporations Act 2001* (Cth) (CA) in respect of the property of several officers and former officers of companies in the Westpoint Property and Finance Group, to bring within their scope property held by a third party as trustee for any trust of which the defendant was a beneficiary, including a superannuation fund.

ASIC submitted that a beneficiary under a discretionary trust has a contingent interest within s 9 CA and that the court could make the orders sought on the basis that a defendant who is a beneficiary of a discretionary trust has a contingent interest in the property of the trust which therefore constitutes property as defined in s 9 CA.

Section 1323(1)(h) CA provides that:

> *The Court may, upon application by ASIC or by the aggrieved person, make one or more of the following orders:*
>
> *...*
>
> *(h) an order appointing:*
>
> *(ix) if the relevant person [in this case each of the Individuals] is a natural person — a receiver or trustee, having such powers as the Court orders, of the property or of part of the property of that person ...*

Crucial to the court's consideration of the proposed orders is the definition of "property" in s 9 CA which reads:

> ***Property** means any legal, equitable estate or interest (whether present or future and whether vested or contingent) in real or personal property of any description and includes a thing in action.*

The question therefore became whether the property of the trusts of which the individuals were beneficiaries can somehow be classed as property of the Individuals themselves, or whether the beneficiaries had an interest in the assets of those trusts sufficient to constituent property so that those interests could be the subject of the appointment of receivers.

French J (as his honour was then) referring to the decisions in *R and I Bank of Western Australia Ltd v Anchorage Investments Pty Ltd* (1992) 10 WAR 59, *Gartside v Inland Revenue Commissioner* [1968] AC 553, *Ascot Investments Pty Ltd v Harper* [1981] HCA 1, *In the Marriage of Ashton* (1986) 11 Fam LR 457, and *In the Marriage of Goodwin* (1990) 101 FLR 386, made the following comments:

- In the ordinary case, the beneficiary of a discretionary trust, other than the beneficiary of an exhaustive trust, does not have an equitable interest in the trust income or property which would fall within the definition of property in s 9 and be amenable to control by receivers under s 1323 (at [29]).

- The "ordinary case" is to be distinguished from the case in which the beneficiary effectively controls the trustee's power of selection. Then there is something which is akin to a proprietary interest in the beneficiary (at [29]).
- A beneficiary of a discretionary trust, at arm's length from the trustee, does not have a contingent interest but rather an expectancy or mere possibility of a distribution (at [36]). On the other hand, where a discretionary trust is controlled by a trustee who is the alter ego of a beneficiary, a contingent interest may be identified as it is as good as certain that the beneficiary will receive the benefits of distributions (at [36]).
- A beneficiary who effectively controls the trustee's power of selection because he is the trustee or one of them and/or has the power to appoint a new trustee has something approaching a general power and the ownership of the trust property (at [37]).

Potential application to bankruptcy proceedings

The trustee in bankruptcy is entitled to claim the debtor's property owned at or acquired after the commencement of bankruptcy.

"Property" is defined in s 5(1) of the *Bankruptcy Act 1966* as:

> ***property*** *means real or personal property of every description, whether situate in Australia or elsewhere, and includes any estate, interest or profit, whether present or future, vested or contingent, arising out of or incident to any such real or personal property.*

This definition is similar to that in the CA and both definitions refer to contingent interests. The effect of the decision in *Richstar* could represent a considerable expansion of the property amenable to distribution by the bankruptcy trustee.

General law context v family law decisions and Richstar

In contrast to the approach adopted in *Richstar* and *Spry*, the decision in *Public Trustee v Smith* [2008] NSWSC 397 (*Smith*) which was decided by the NSW Supreme Court after the *Richstar* and *Spry* decisions is consistent with established trust and equity principles, and emphasises that the appointor or controller of a trust is *not* the beneficial owner of the trust's property.

In this case, a gift by the testatrix of a house she described in her will as "my property" was held to be ineffective because the property was owned by the corporate trustee of a family trust, even though the testatrix was the sole shareholder and director of the trustee company and controlled the trust. The testatrix was not the sole beneficiary or beneficial owner of the property. White J (at [105]) denied that the testatrix as controller of the company was beneficially entitled the trust's assets:

> *Indeed, to say that a person who controls a trustee which holds property on trust for others, rather than the beneficiary of the trust, is beneficially entitled to the trust property, is inconsistent with the very notion of a trust.*

His Honour distinguished between the general law context and the family law decisions, observing:

> *In some of the cases, findings that property of the trust is to be treated as if it were the property of the husband has been supported by findings that the trustee was the "alter ego" or "puppet" or "creature"*

of the husband. It is not clear to me what the significance of such a finding is unless it is another way of saying that the husband controls, or is in a position to control, the exercise of the trustee's powers; which in turn simply raises the question as to whether such control amounts to ownership, or should be treated as if it did amount to ownership … [118]

It is perfectly understandable that in the context of s 79 the expression "property of the parties to the marriage or either of them" should be read as extending not only to property owned by a party to the marriage but also property controlled by a party to the marriage where the control is such as to put the party in the same position as if he or she were the owner of the property. That is how I understand the family law cases to have proceeded … This is the context in which the family law cases must be read. In my view, they do not support the wider proposition that as a matter of general law an object of a discretionary trust can be described as the beneficial owner of the property held by the trustee, merely by virtue of his or her being a discretionary object and also controlling the trustee. [125]

His Honour also accepted (at [138]) that in the context of receiver orders, the notion of property could be extended to property effectively owned by a person for the same reasons as discussed in the family law cases concerning s 79 FLA, but observed that *Richstar* did not establish that because a discretionary beneficiary controls the appointment or removal of the trustee, or controls the exercise of the trustee's powers, that person is the beneficial owner of the trust property, irrespective of the terms of the trust deed:

French J did not say that it followed from the defendants' positions as beneficiaries of discretionary trusts and their control of the trustees that this amounted to actual ownership as distinct from "effective ownership". As with the reference to "de facto ownership" I take the phrase "effective ownership" to mean that the defendants had such control of the affairs of the trust that they were in as good a position as if they were the beneficial owners, but not to mean that they were the beneficial owners of the trust property. ***In my view, there is very sound reason for construing the expression in s 1323(1)(h)(i) "an order appointing a receiver or trustee of the property of [the relevant person]" as extending not only to property actually owned by the relevant person but property effectively owned by him or her, for the same reasons as discussed in the family law cases concerning s 79 of the Family Law Act.*** *However, I do not understand ASIC v Carey (No 6) to establish that because a beneficiary of a discretionary trust controls the appointment or removal of the trustee, or controls the exercise of the trustee's powers and can appoint trust property to himself or herself, that the holder of such a power is the beneficial owner of the trust property irrespective of the terms of the trust deed.* (emphasis added)

Consequences for asset protection — generally

The decisions in *Smith* and *Lygon Nominees* reinforce traditional trust law principles, but they provide little comfort from an asset protection perspective. In *Smith*, White J accepted that s 79 FLA and s 1323(1)(h)(i) CA provided an exception to the general law position.

The discussion above illustrates that following *Richstar* and *Spry,* the greater the degree of control an individual exerts over a trust, for example, as the appointor or sole director and shareholder of a corporate trustee (and of relevance in the context of receivers orders and bankruptcy, as the spouse of such a person), the greater their capacity to benefit from it and therefore it is more likely that the court would construe the trust's assets as property of that individual.

Appointment of an independent appointor

It has not yet been suggested that the person who has the power to appoint or remove trustees of a discretionary trust (appointor) has any interest in the trust fund of the trust.

The question of whether an appointor's power of appointment constitutes property for the purposes of the *Bankruptcy Act 1966* was considered in the case of *Re Burton; Wily v Burton & Ors* (1994) 126 ALR 557 (a case not referred to in *Richstar*), where it was concluded (at 560) that:

> *... as the interests of the beneficiaries must be taken into account, and the power exercised in their interest, the power which Mr Burton holds as appointor is not "property" which vests in his trustee in bankruptcy nor a power "as might have been exercised by the bankrupt for his own benefit".*

These features reinforce the importance of having an independent individual such as a trusted business adviser, accountant or lawyer assume the role of appointor of the trust.

While the operation of Pt VIIIAA FLA has perhaps diminished the effectiveness of using an independent appointor in the family law context, an independent appointor will still be a relevant factor in family law, bankruptcy and receivers' orders proceedings, when assessing the degree of control that an individual exerts over a family trust.

The extent of the trustee's control of the trust property may also be restricted by expanding the role of the appointor to include a requirement for the trustee to obtain the appointor's consent for significant distributions of capital, variations or amendments to the trust deed, bringing forward the vesting date and obtaining asset protection advice from a lawyer or accountant with expertise in that area prior to winding up the trust prior to the vesting date.

If the trust has an independent appointor and a corporate trustee, of which the wife is the sole shareholder and director and the husband is an excluded beneficiary it may be difficult to argue in the context of bankruptcy proceedings and receivers' orders that on *Richstar* principles, the trust's assets are the "property of" the individual. However, it may be arguable that the husband does benefit from the trust if, the trust has previously distributed income and/or capital to a second family trust in which the husband is a beneficiary, and that second trust has made distributions to him.

Directors and shareholders of corporate trustees

Before *Richstar*, it would probably not have been thought necessary to consider whether the director or shareholder of a corporate trustee of a trust might have an interest in the trust fund of that trust. A director has the day-to-day running of the company and is subject to removal by shareholders. Directors do not own or have an interest in the assets of the companies of which they are directors. Similarly, shareholders of a company (unlike unitholders in a unit trust) do not have any interest in the assets of the company in which they hold shares, their property being the bundle of rights that is the shares themselves.

Notwithstanding this, *Richstar* appears to conclude that a person who is a director and shareholder of the corporate trustee of a trust may, by them being in effective control of the trustee, and in combination with the coincidence that they are also a beneficiary of the trust, have a proprietary interest in the trust fund. The assumption made is that in these situations the company is really the “alter ego” of the beneficiary, and in particular relies on a number of cases in the family law jurisdiction.

The position appears to be different in the context of the legislative scheme governing the small business CGT concessions. In *Gutteridge & Anor v FCT* [2013] AATA 947, for instance, the Administrative Appeals Tribunal held that the sole director and shareholder of a corporate trustee of a discretionary trust was not a controller of the trust. A critical assessment of the way in which the trust was managed was necessary to find that it was Mr Gutteridge, rather than his daughter, who controlled the trust.

The issues needed to be addressed in a family law context (where one is considering what assets should be taken into account in making an order for the adjustment of property in a family law dispute) are very different to the issues that arise in *Gutteridge* and *Richstar* and in the area of the availability of assets in a commercial insolvency context.

Combination of the above

Even if *Richstar* is incorrect and the otherwise understood position that none of the above persons (apart from the trustee and default beneficiaries) by themselves can have any interest in the trust fund of a discretionary trust, can the positions be somehow aggregated as factors to be considered to determine whether the requisite interest exists? This appears to be the analysis and conclusion in *Richstar* and *Spry*, in that where a person happens to be a beneficiary of the trust and, in some other role, has some effective control of the trustee, then they have an interest, whereas if only one such factor applied they would not have an interest.

If it is correct that a mere object of a discretionary trust does not have an interest in the trust fund of that trust, and if it is also correct that the power of an appointor to appoint and remove trustees is not property of the appointor, then it is difficult to comprehend that these principles may change just because a particular example of each category of persons is or can be the same person. It is, however, possible that this “aggregate” kind of approach may find favour in the court. It is not unlike the analysis that the ATO has used in its “statement of principles”, where it gives its views on when changes to a discretionary trust may cause a resettlement of that trust. The approach is also enshrined in the process of considering whether or not tax avoidance has occurred under Pt IVA ITAA36, where a number of factors are looked at and weighed up.

Trustee’s powers

There is no analysis in *Richstar* or *Spry* of the extent of the powers of the trustees of the discretionary trusts concerned, and so it is unclear whether or not the trustees had a general power of appointment; nor is it explained how a beneficiary who “effectively controls the trustee” can be viewed as standing in the shoes of the trustee so that it is the beneficiary itself who has the general power, if it is indeed a general power. The corporate veil between a company and its directors and/or shareholders appears to have been lifted. If a corporate trustee can be simply viewed as the “alter ego” of its directors/shareholders, then this will represent a significant shift in the law of trusts as it is applied to standard discretionary trusts in the commercial world.

Alternative view

There has been some concern that the decision in *Richstar* may have broader implications when determining whether discretionary objects of a discretionary trust have an interest in the trust. Those concerns appear to have been somewhat alleviated by Goldberg J of the Federal Court in *Kawasaki (Australia) Pty Ltd v Arc Strang Pty Ltd* [2008] FCA 461 where he commented on the impact of the decision in *Richstar* on the principles outlined in *Lygon Nominees Pty Ltd v Commissioner of State Revenue* as follows:

> *There is nothing in the reasoning of French J in Australian Securities and Investments Commission v Carey (No. 6) (2006) 153 FCR 509 which doubts these principles in relation to the nature of interests in or under a discretionary trust. French J was concerned with the content and extent of a contingent interest for the purposes of s 9 of the Corporations Act 2001 (Cth). [75]*

Accordingly, in a modern trust structure the general principle is that a beneficiary does not have an equitable proprietary interest in the trust assets that constitutes beneficial ownership of any of those trust assets. However, for the purpose of at least the FLA and s 9 CA — and perhaps other legislative provisions — it appears the potential for a trustee, who has a general power of selection, to have a proprietary interest in a trust fund is being attached to the position of a director and shareholder of that corporate trustee, who happens also to be a beneficiary of the trust.

If indeed the ability to have effective control over a trustee's power of selection is a relevant issue, then it must relate to the circumstances or position that give rise to that power or control, ie it is the fact of being a trustee or a director or shareholder of the trustee (or perhaps an appointor of the trust) that is relevant, not the person's coincidental position as a beneficiary of the trust. It seems that if some doctrine of effective control is developed, then it will not change the answer to the question of whether or not a mere object of a discretionary trust has an interest in the trust fund of the trust.

Questions that will be asked of the court in the future

There are a number of questions that the court will ask or will have asked of it in the context of discretionary trusts. The answers to these questions will be relevant when determining the fate of the assets held in those trusts. Some of the more important questions are set out below.

Trustees	1.	What is the identity of the trustee of the trust — is it a company or an individual, and if a company, who are the directors and shareholders?
	2.	Can the trustee benefit themselves either directly or indirectly from the trust?
	3.	Is the trustee effectively controlled by someone else, eg through director/shareholder of a corporate trustee or through an appointor?
	4.	Is the trustee merely the "alter ego" of some other person?
	5.	Is the trustee's power to distribute income or capital restricted in any way, eg is the consent of some other party required?

Beneficiaries	1.	Who are the potential beneficiaries of the trust?
	2.	Who are the default beneficiaries?
	3.	Are the beneficiaries limited to a particular class?
	4.	Can beneficiaries be added or deleted, and if so, who has the power to do this?
	5.	Do all beneficiaries have the same potential to receive income and capital?
Appointors	1.	Who are the appointors of the trust?
	2.	Can the appointors benefit themselves from the trust?
	3.	Does the appointor usually act in accordance with the wishes of some other person?
	4.	Is an "independent" appointor really just the "alter ego" of some other person?
	5.	Must appointor decisions be unanimous?

Having answered the above and other relevant questions, the court may determine whether or not the relevant parties have an interest in the property of relevant trusts by considering the answers in a combined context.

Consequences for asset protection — family law

Property acquired by the parties to the marriage during the marriage

As discussed above, the majority of the High Court in *Spry* considered it relevant that the trust property in that case was acquired by the parties to the marriage during the marriage.

The decision in *Spry* enhances the importance of testamentary trusts in protecting assets from FLA property settlement orders, as if a testamentary trust has been established by a parent of one of the parties for the benefit of that child and their family, the assets of the testamentary trust should be protected to a greater degree from FLA orders as those assets were not contributed by the party (cf traditional inter vivos discretionary family trust).

There is potential also for a testator to prefer to establish a single testamentary trust for all of his or her children and to provide for more than one child to control the trust so as to limit the exposure to family law claims that could otherwise result where each child is the primary beneficiary of his or her own testamentary trust. This practice could result in increased pressure on a spouse from his or her siblings (who are also the primary beneficiaries of the testamentary trust) to settle family law property claims out-of-court.

Planning

The issues raised in the family law decisions considered above and *Richstar* are significant and require anybody with an existing discretionary trust, or who is proposing to use a discretionary trust, to carefully consider who should fulfil the various roles of trustee, directors, shareholders, appointors and default beneficiaries.

A memorandum of wishes, where the settlor or a testator (in the case of a testamentary trust) records in writing their hopes and wishes for the future administration of the trust, is an alternative form of planning. Such a memorandum may be desirable for providing guidance or a reference to the trustee as to the administration of the trust, and may also help the family to resolve issues arising over the years and avoid litigation. However, if legal proceedings ensue, courts may also refer to the memorandum to ascertain the settlor's or testator's intentions when resolving the matter.

The challenge will be to get the right combination to minimise any possible attacks on the assets of the trust, without comprising the flexibility and control of the trust from the point of view of asset protection, taxation, succession and estate planning.

¶2-125 Trusts in the family law arena

The common use of trusts for business and investment structuring means that issues concerning the control of trusts, distributions and loans from trusts (both from the past and into the future) and beneficiaries of trusts have now become matters that family lawyers must consider. To solve these problems requires knowledge of both trust law and taxation issues.

The purpose of this paragraph is to provide an introduction to the trust issues that can arise when considering trusts in the family law context, and to consider the implementation of family law orders relating to trusts.

This paragraph focuses on discretionary trusts in the family law context.

Changes to control

The key parties involved in the control of a trust are the trustee and the appointor.

Trustee

If the trustee is a company, it will be necessary to review the identities of the directors and shareholders of the company. Commonly, the directors and shareholders of the company may have been both the husband and wife. Therefore, if the control of the trust is to be transferred to one party (the continuing party), it will be necessary for the other party (the outgoing party) to resign as a director and transfer their shares to the continuing party, or an entity nominated by him or her. Before this can be done, the constitution or articles of association of the company should be reviewed to ensure that it allows a single director to control the company.

The constitutions of companies incorporated before 1997 will generally have a minimum requirement that two directors be appointed. In these circumstances it will be necessary prior to the resignation of the outgoing party to amend the constitution to allow a single director.

In relation to the change in shareholding, consideration should be given to the shares being transferred from the outgoing party to a protected entity or an individual that is not subject to the same business risks as the continuing party.

If the trustee is the husband and wife jointly, then resignation of the party that is not to control the trust will obviously be necessary. It would also be prudent at this time to analyse whether it is appropriate for the continuing party to remain as the sole trustee. If the trustee operates a business, then the preferred structure would be to appoint a corporate trustee. If the trustee holds investment assets, then careful consideration should be given to the risk profile of the continuing party.

Whether the trustee is a company or individuals, it is important that the trust deed is reviewed to identify the process set out in the trust deed for the removal and appointment of trustees. A common requirement is for the appointment and removal to occur by deed and to be executed by the retiring trustee and the new trustee. If the process in the deed is not followed, then the removal and appointment may be invalid. A requirement to execute the documents to record the retirement and appointment should be incorporated as part of the family law orders.

Appointor

The position of appointor is arguably the most important position in relation to the control of a trust, because the appointor has the ability to remove the trustee.

The appointors of a trust will usually be individuals, and commonly a husband and wife jointly. Therefore, control of this position needs to be transferred to the continuing party. In making this change it is important to consider the risk profile of the continuing party. If the risk profile is unacceptable, then the appointment of an independent person to act jointly with the continuing party may be appropriate.

When changing the appointor, it is again necessary to review the provisions of the trust deed in relation to how this change can be made. Some trust deeds contain provisions that only allow an appointor to nominate a replacement that will act in substitution for the original appointor, but not confer a right of survivorship. This means that the new appointor cannot nominate a replacement, even on his or her death. If a trust deed contains such a restriction, then it is important that it is identified and taken into account in the succession plans for the trust.

Unpaid beneficiary entitlements and loan accounts

Loan accounts with credit balances and unpaid beneficiary entitlements (UBEs) (credit trust entitlements) can be addressed in two ways:

(1) If a cash payment to one party from the trust is required pursuant to the terms of settlement, this can be made by paying the credit trust entitlement to the entitled party, or if the credit trust entitlement is in favour of the other party, then payment can be made to that party, who can then make a gift of that amount.

 Alternatively, if a payment is not required from the trust, an assignment of the credit trust entitlement to the continuing party (or an entity nominated by him or her) should be made. The assignment should not only be reflected in the financial statements of the trust, but also recorded in a written document signed by both parties. Further, before the assignment is effected, asset protection should be considered. If the continuing party is exposed to risk, the assignment should be made to a protected entity.

(2) If the credit trust entitlement is a UBE, then it will be important to review the provisions of the trust deed to determine how these amounts are characterised for trust purposes. Commonly, trust deeds will provide that these amounts are held on separate trusts for the beneficiary. If this is the case, then it is the beneficial interest in this separate trust that is being assigned, and this should be reflected in the written document recording the assignment.

The task of dealing with the loan account of an outgoing party is more difficult if it has a debit balance. The tax implications that arise under Div 7A ITAA36 are dealt with in ¶7-115 of this guide (and in the discussion below), and it is imperative that they are considered in the family law context. The forgiveness of a loan owed by an outgoing party may give rise to a deemed dividend. The assignment of the liability to the continuing party will not directly give rise to adverse tax implications, but may increase the repayment obligations of the continuing party to an unsatisfactory level. If there are sufficient funds to repay the loan, this is the preferred option. Whether the loan is assigned or repaid, it should be recorded in writing.

Changes to beneficiaries

A trust will generally have two classes of beneficiaries — primary or specified beneficiaries, who are often the takers in default in relation to undistributed trust income; and general beneficiaries, who usually consist of a wide range of individuals, companies and trusts. No single beneficiary of the trust has an ownership interest or an entitlement to the trust fund.

When making the decision to continue to control the trust, the continuing party must ensure that they are a beneficiary of the trust. Some trusts exclude the settlor, the trustee and individuals who have made capital contributions to the trust. It is important to review the trust deed to determine whether such exclusions are included.

While a beneficiary of a trust does not have an entitlement to the trust fund, if they are a primary beneficiary they may receive a distribution if there has not been an effective distribution of income or if the trust reaches its termination date without being vested earlier. Therefore, if the outgoing party remains as a primary beneficiary, a distribution to them may arise through the operation of the provisions of the trust deed.

To avoid the unintended consequences of a distribution being made to an outgoing party, the outgoing party's interest as a beneficiary should be renounced. The trust deed should be reviewed to determine whether there is a process set out for the exclusion of a beneficiary. In the absence of a provision being contained in the trust deed, the execution of a deed by the outgoing party will operate as an effective renunciation of the beneficiary's interest. Care should be taken to ensure that the outgoing party has received all distributions from the trust contemplated as part of the family law settlement before his or her interest is renounced.

Whether the removal of a primary beneficiary from a trust is a variation to a trust deed that creates a resettlement of the trust is unclear, and will depend on the beneficiary provisions contained in the trust deed. This is a matter that should be considered prior to the interest being renounced.

How are family law orders made?

To understand family law orders and their application to trusts it is important to consider the context in which they are made. Approximately 95% of family law disputes resolve by negotiation, without a determination of the Family Court, either before or after Family Court proceedings are issued.

Property orders to deal with the distribution of the property of the marriage can either be made as a consequence of an application made by the parties for consent orders, or alternatively, to resolve an application brought by the parties for the Family Court to make a determination. In both cases, the orders reached by agreement must be approved by the Family Court. Prior to the orders being approved by the Family Court, it is necessary for full financial disclosure to be made by both parties. In addition, a judicial officer of the Family Court must be satisfied that the orders result in an outcome that is in the range of a reasonable settlement.

As an alternative to property orders approved by the Family Court, parties now have the opportunity to enter into a binding financial agreement to effect a distribution of the property of the marriage. To be valid, the agreement must be certified by an independent lawyer for each party.

As a separate step to making orders relating to the property of the marriage, a divorce order can be made by the Family Court. Under the FLA, "divorce" means the termination of the marriage other than by the death of a party to the marriage. One party to a marriage can make an application to the Family Court requesting that a divorce order is made. In most family law matters, a property settlement will occur before an application for a divorce is made.

Where trusts are involved, property orders for the distribution of the assets will frequently contain the following provisions:

- An obligation that the party who will retain control of a trust (the continuing spouse) pay or cause to be paid an amount of money to the outgoing spouse who will no longer benefit from the trust.
- Contemporaneously with the payment of the monetary sum, the outgoing spouse:
  - resign as a trustee or a director of a corporate trustee of the trust and transfer any shares held in the corporate trustee;
  - resign as an appointor of the trust; and
  - assign to the continuing spouse any beneficial entitlement he or she may have in the trust, including any credit beneficiary entitlement and any credit loan account.
- The outgoing spouse renounce or relinquish any interest in the trust.
- The continuing spouse assume any liability of the outgoing spouse to repay a loan to the trust.
- The continuing spouse indemnify the outgoing spouse in relation to any liability that may arise out of the outgoing spouse's position as a trustee (or director of a corporate trustee), appointor or beneficiary.

How are the orders implemented and what are the consequences?

Payment of money from the trust

Although the Family Court has power to make orders in relation to third parties, property orders will in most cases require the continuing spouse to source the funds from a trust, instead of requiring a trustee to make a payment.

If a distribution is to be made from a trust directly to an outgoing spouse, it will be important to ensure the following:

- that the outgoing spouse remains a beneficiary of the trust, as defined by the trust deed; and
- if a family trust election (FTE) has been made in relation to the trust, the identity of the primary individual for the purpose of the FTE (FTEs are made in accordance with s 272-80 contained in Sch 2F ITAA36). Similar issues to those in relation to an FTE arise where an interposed entity election has been made in accordance with s 272-85 of Sch 2F ITAA36. This will be crucial where a divorce order has been made.

  The existence of an FTE in relation to a trust does not prohibit a distribution being made to an outgoing spouse. The amendments to Sch 2F ITAA36 by the *Tax Laws Amendments (2007 Measures No. 4) Act 2007* changed the definition of "family group" to include former spouses. Section 272-90(2A)(a) to (c) ITAA36 now provides for former spouses to be included in the definition of "family group" (see ¶7-130 of this guide).

Change in control of the trust

When implementing property orders, emphasis should be placed on transferring control of a trust contemporaneously, with a requirement to transfer property to the outgoing spouse. To achieve this, the following steps should be considered:

- If the trust has a corporate trustee and the outgoing spouse was a director, the outgoing spouse must resign. If the outgoing spouse held shares in the corporate trustee, these must be transferred to the continuing spouse or an entity associated with the continuing spouse. It is important that the appropriate minutes, notices and Australian Securities and Investment Commission forms are completed and lodged.
- If the outgoing spouse is a trustee of the trust, then he or she must be removed from this position.

  The trust deed will prescribe the process for this to occur. It must be strictly followed. After the removal of the outgoing spouse as trustee, a review of the trust property should be undertaken. Any property that records the outgoing spouse as a registered owner must be transferred to the new continuing trustee(s). This is particularly important where the trust owns real property.
- The removal of the outgoing spouse from the position of appointor is crucial. The trust deed should be reviewed to determine the process for removing the appointor. Again this must be strictly followed to ensure that the removal has been effective.

Relinquishing entitlements, satisfying obligations and indemnities

The existence of a credit beneficiary entitlement owing to an exiting spouse or a loan with a credit balance in favour of an exiting spouse can be resolved by recording the assignment or relinquishment in writing. The trust deed should be reviewed to determine the nature of the entitlement to ensure that it is accurately described and effectively assigned or relinquished.

As noted above, a debt owed by an outgoing spouse to a trust may cause difficulties. The extinguishment of the debt must be treated cautiously where the trust has an unpaid present entitlement to a company. The forgiveness of a debt in these circumstances may give rise to a deemed dividend under the provisions contained in Div 7A ITAA36. The assignment of the debt to the continuing spouse may avoid this problem, but may increase the continuing spouse's repayment obligations.

To forgive or assign the debt, a written instrument should be entered into between the trustee of the trust, the continuing spouse and the outgoing spouse. This change in financial position in relation to this amount must then be reflected in the financial records of the trust.

The property orders will commonly include an indemnity by the continuing spouse for any liabilities that arise in relation to the trust that are the subject of a claim made against the outgoing spouse. The outgoing spouse will simply be able to rely on the property orders to enforce the indemnity. An outgoing spouse who was previously a trustee of the trust may also have a right of indemnity against the trust assets under the trust deed, if such a claim arises.

Taxation considerations when calculating a family law settlement

Distributing assets from trusts or liquidating assets held by trusts in order to satisfy obligations under property orders will often have tax consequences.

These consequences and the tax cost are taken into account in the family law context when determining the value of the property available for distribution (*Rosati v Rosati* [1998] FamCA 38). Therefore, the cost of any CGT or income tax resulting from the trust distributions and payable by beneficiaries will be taken into account when determining the net value of the property being dealt with in the property orders, as well as the amounts distributed to each party.

Taxation considerations of orders to set aside transactions

The effect of an order setting aside a transaction appears to be retrospective and will not take effect from the date of the order or such other date the court determines.

As explored by Arlene McDonald in a paper presented at The Tax Institute's 24th National Convention "Trust Busting and the Family Court", in *Stephens and Stephens & Ors* [2005] FamCA 1181, Strickland J's approach indicates the effect of the Family Court setting aside a transaction pursuant to s 106B is that the transaction did not happen (at paras 189.1.1 and 189.1.2):

> *The instrument executed by the husband as settlor on 7 December 1998 should be set aside. The effect of this is that … the husband remains a capital and income beneficiary of the Stephens Trust. The instrument executed by the husband as trustee on 18 January 2002 whereby the income and capital of the Stephens Trust was applied to the four children's trusts should be set aside. The effect of this is to return the capital and income of the children's trusts to the Stephens Trust.*

The retrospective effect of an order to set aside has the following taxation consequences:

- Certain beneficiaries may have incurred tax liabilities on income to which they were not presently entitled (even though everyone at the time believed they were) when default beneficiaries or the trustee (if no beneficiary was or deemed to be presently entitled) would have been liable for the income tax and amendment periods have expired.
- CGT or stamp duty issues may arise if on divorce the outgoing spouse is to no longer be a beneficiary of the trust and so not entitled to any distribution of capital or income.

- If a trustee is ordered to distribute all of the income and capital of the trust to the outgoing spouse then there may be an instance where there are no trust funds to pay out the unpaid beneficiary entitlements.

The ability to counteract these consequences will rely on the terms of the trust deed and resolutions made by the trustee as to the appointment of income for the period. If the time to amend the assessment is running out there are options to consider in obtaining an extension of that time period including making an application to the Commissioner before the time period expires (s 170(5) ITAA36) or lodging an objection even to the return as lodged (s 170(1) table item 6(b)).

Taxation considerations when transferring property out of a trust

There is potential for unintended Div 7A ITAA36 consequences to be triggered where property is transferred out of a trust.

For example, if the Family Court orders a trustee to transfer property to the outgoing party out of the trust pursuant to s 90AE FLA and there is any UBE owing by the trust to a corporate beneficiary (or any other entity in which the parties are shareholders) at the time of a transfer or at the earlier of the due date for lodgment and the date of lodgment of the trust's income tax return, the distribution will result in the outgoing party being treated as having received a frankable dividend from each of the entities to which a UBE is owed (ss 109XA(1), 109XB(1) and (2), and 109RC(3) ITAA36). This will occur even though the trustee is not party to the Family Court proceedings (ID 2004/461 and ID 2004/462).

Following the transfer, the outgoing spouse will have to include the market value of the property transferred and the amount of the franking credit (which will depend on each corporate beneficiary's benchmark franking percentage) in their assessable income for the relevant financial year and will be entitled to a tax offset equal to the franking credit (s 207-20(2) of the *Income Tax Assessment Act 1997* (ITAA97)).

In this instance the outgoing spouse should ensure that any future tax liability is factored into the settlement orders or alternatively, that they are provided with an indemnity by the trustee and the continuing party. Alternatively the outgoing party could request that the Family Court order be made as a two-step process, whereby the property is first distributed by the trustee to the continuing party and then by the continuing party to the outgoing party. Any Div 7A deemed dividend issue will then be a liability for the continuing party personally and the outgoing party will not be required to enforce any indemnity against the trustee or the continuing party.

Planning

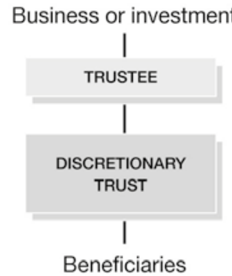
The implementation of property orders arising from family law disputes is complicated where trusts are involved. A thorough analysis of the control of the trust, the assets held by the trust and the provisions of the trust deed must be undertaken. This will enable both the family law and trust issues to be resolved.

Chapter 3

Trust structures

When using chapter 3 of this guide, it is recommended that, if you read a detailed guide, you also read the applicable key points guide as not all information provided in a key points guide will be covered in the detailed guide for a particular structure. The detailed guides elaborate on the unique aspects of structures, while the key points guides address the common issues concerning structures.

¶3-100 The standard discretionary trust

Key points guide	Diagram	 Note: More comprehensive diagrams are provided in the detailed guide.	
	Suggested application	■ To own and operate a business on behalf of a single family. ■ To hold a family's passive investments (inc shares or property). ■ To hold a family's interest in a partnership business.	
	Parties	Who is the legal owner of the assets and makes decisions on a daily basis?	The trustee
		Who owns a beneficial interest in the assets?	The class of beneficiaries (but they do not have a fixed interest)
		Who establishes the structure?	The settlor
		Who appoints the legal owner?	The appointor
	Asset protection	■ The structure is protected from claims by creditors of beneficiaries. ■ Beneficiaries are protected from claims by creditors of the structure. ■ Assets are protected from claims by future spouses of principals and children. Note: the indication of the availability of asset protection is based on the structure itself. Care should always be taken to review loans, entitlements and any personal guarantees that may exist between the various parties.	
	Income taxation	■ Income accumulated by the structure will be taxed at the highest marginal income tax rate plus the Medicare levy. ■ Flow-through taxation applies, so that income distributed by the structure will be taxed in the hands of the recipient at their income tax rate. ■ There is flexibility to distribute income (including income with special characteristics, eg franked dividends) to any one or more beneficiaries (subject to personal services income and Pt IVA issues).	

Key points guide	Capital gains tax concessions		50% discount	✓ Available
		Small business concessions	50% active asset reduction	✓ Available
			15-year exemption	✓ Available (if there is a significant individual[1] throughout a total of 15 years)
			Retirement exemption	✓ Available (if there is a significant individual[1] in year of disposal)
			Roll-over	✓ Available
		Note: the availability of CGT concessions only relates to the availability to the structure. Consideration must be given to the requirements for accessing the concessions outlined in the ITAA97 and the requirement to distribute amounts of net capital gains in some circumstances to avoid the benefit of the concession being eroded by the gross-up rules in Subdiv 115-C ITAA97.		
	Succession planning (estate planning)	■ The assets of the structure are not owned by any one beneficiary and do not form part of a beneficiary's estate on their death. ■ Ultimate control of the trust resides with the appointor. ■ Ultimate control of the structure may be planned by appropriate drafting of the appointor provision.		
	New investors	■ Beneficiaries may be added to the structure. Adding beneficiaries may cause a resettlement that incurs CGT and stamp duty liabilities. Resettlements are discussed in ¶7-125 of this guide. ■ The structure is not capitalised by beneficiaries.		
	Other issues	The trustee on behalf of the trust may need to make a family trust election if: ■ a beneficiary is to receive the benefit of franking credits attaching to dividends paid in respect of shares acquired after 31 December 1997; and ■ the beneficiary will have greater than $5,000 in franking credits (in total and from all sources) in the applicable financial year.		

1 A "significant individual" is an individual who has a small business participation percentage[2] in the trust of at least 20% (see s 152-55 ITAA97).

2 The meaning of "small business participation percentage" is outlined in ¶3-110 of this guide.

Detailed guide — the standard discretionary trust

A discretionary trust's major features are its capacity to protect assets and its capacity to provide a flexible arrangement for the distribution of profits. The use of discretionary trusts to take advantage of concessional tax treatment is also important. The taxation of trusts is a highly complex and continually evolving area of law. Chapters 6 and 7 specifically address various issues relating to the taxation of trusts.

The establishment and workings of a discretionary trust

A family trust, in which the primary beneficiaries comprise one family group, is an example of a particular type of discretionary trust. The following example will illustrate the establishment, operation and advantages of a discretionary trust.

For more explanation of the advantages of a discretionary trust, see "Advantages of a discretionary trust" at page 90.

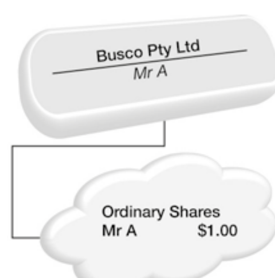
In this example, Mr A wants to establish trust arrangements for business and family purposes. Mr A is married to Mrs A. They have three children: B, C and D. The family has known Mr X and Ms Y for some time, as close and trustworthy friends.

The A family wants the trust arrangement to deal with both active assets and passive assets. An active asset is one in respect of which a liability can be incurred. For example, the goodwill of a business is an active asset as customers and suppliers of the business could bring an action against the business proprietor seeking compensation for any damage suffered as a result of a breach by the business proprietor of the terms of their contractual relationship. A passive asset is one in respect of which no future liability can be incurred. For example, shares represent a passive asset as, once they are fully paid up, no further liability can attach to the shareholder.

Active and passive assets should generally be kept in separate trusts by different trustees. The aim of this is to protect the passive assets from being used to satisfy a claim made in respect of an active asset. If one trust held both active and passive assets and if a person successfully brought an action against the trustee of the trust, it might be necessary to sell the passive assets to satisfy the order made by the court. Generally, this could not happen if a different trustee held the passive assets in a different trust.

Accordingly, it would be recommended that Mr A have two separate discretionary trusts established, with different trustees.

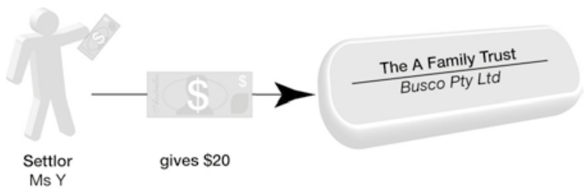
Step 1: Mr A incorporates the trustee companies. Mr A incorporates a company (Busco Pty Ltd) of which he is the sole director and shareholder. Mr A also incorporates Investco Pty Ltd.



Mr A uses Busco Pty Ltd and Investco Pty Ltd as trustees of the discretionary trusts he is setting up (the A Family Trust and the A Investment Trust).

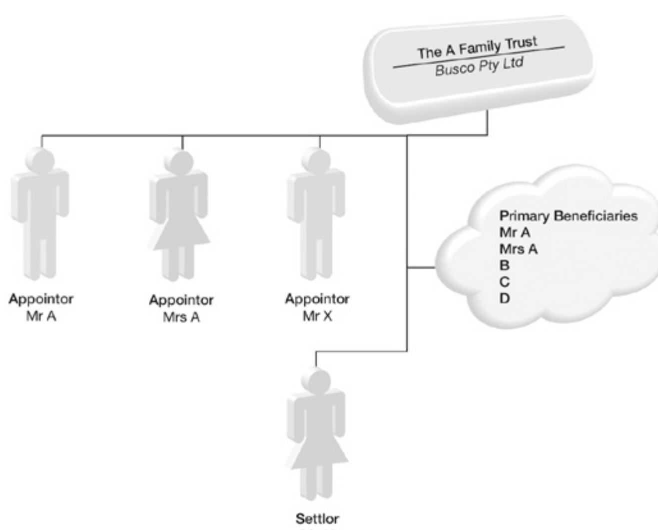
Step 2: The settlor pays the settled sums to the trustee. The settlor pays a nominal sum to each of the trustees, Busco Pty Ltd and Investco Pty Ltd, and executes the trust deeds. The settled sums are the initial trust assets (ie the trust funds). The trust funds grow throughout the life of the trusts as the trustees acquire further assets for each of the trusts.

In the present case, a family friend — Ms Y — has decided she will settle the trusts for the benefit of the A Family.



Step 3: Trustees execute trust deeds. Busco Pty Ltd and Investco Pty Ltd execute the trust deed of the trust of which they are the trustee and so complete the establishment of each trust. Each trust deed provides for an appointor and Mr A chooses his friend, Mr X, to be the appointor for each trust, together with himself and his wife. Each trust has Mr A, Mrs A and their three children as primary beneficiaries (as to who is usually a primary beneficiary and who is usually a general beneficiary, see “Who’s who in the trust arrangement” on page 88 of this guide).

The terms and beneficiaries of each trust are identical even though each has a different trustee and each will hold different assets. Busco Pty Ltd (as trustee of the A Family Trust) holds the active assets and Investco Pty Ltd (as trustee of the A Investment Trust) holds the passive assets.

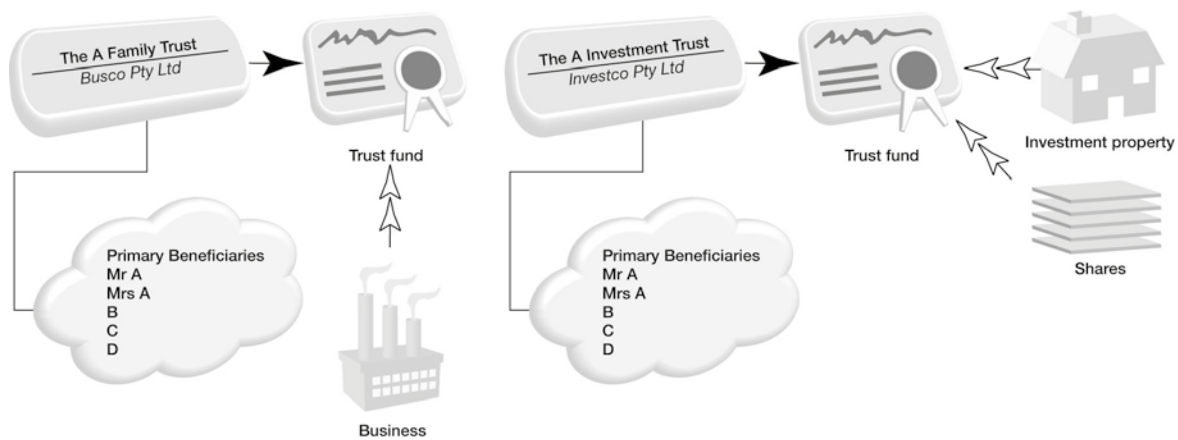


Who's who in the trust arrangement

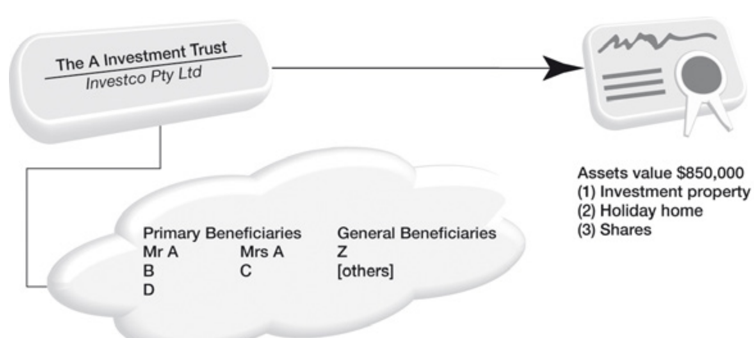
Who's who		
	Settlor	A family friend will usually be the settlor. The settlor is excluded by the trust deed from benefiting in any way from the trust, for example by receiving a distribution of income or capital from it. The settlor will settle property (often money, eg $20) by way of gift to the trustee on the terms of the trust deed. This forms the initial trust property. (Subsequently, the trustee is allowed to increase the trust property by way of borrowing, receiving gifts or acquiring other assets.) The settlor must not be reimbursed for the settlement in any way. That is, he or she must give (without expectation of any return) the initial trust property. Once the trust deed is executed, the settlor has no further role in the administration of the trust and is not subject to further legal obligations, even if the trustee later breaches the terms of the trust.
	Trustee	The trustee can be one or more individuals or a company. If the trustee is a company, its actions are controlled by the directors and, ultimately, by the shareholders in the company by virtue of their power to remove or appoint directors. A trustee is responsible for the day-to-day management of the trust assets, the conduct of any business that the trust may own and for making distributions of income or capital to beneficiaries. If the trustee incurs a liability, in acting honestly as trustee, it is entitled to an indemnity from the trust assets for the liability. However, if there are insufficient assets of the trust to meet that liability, the trustee may be liable for any shortfall. Therefore, if the trustee is an individual, the trustee's personal assets may be exposed to meet any shortfall.
	Beneficiaries	In a well-drafted discretionary trust deed, the trustee can determine to allocate income or capital of the trust to a wide range of beneficiaries. Often there are two categories of beneficiaries: primary beneficiaries and general beneficiaries. Primary beneficiaries are usually family members being principally involved in the business or investments owned by the trust. The family members include parents, children, any grandchildren or prospective grandchildren and further descendants of the family. The initial primary beneficiaries can be named in the trust deed and the others are added automatically by way of definition. General beneficiaries include a wider range of relatives of the primary beneficiaries, such as the primary beneficiaries' spouses and siblings, charitable institutions, any company in which a primary beneficiary holds an interest and any other trust of which a primary beneficiary is also a beneficiary.
	Appointor	Appointors are the persons named in the trust deed who have the power to remove an existing trustee or nominate an additional or replacement trustee. In most circumstances, the parties for whose benefit the trust is established are the original appointors. That is, appointors are often the primary beneficiaries. In the role of determining who the trustee is to be appointors, in effect, control the trust property. If appointors are exposed to business risks, it is wise for there to be an independent appointor in addition to the family members who are appointors. This independent appointor should be someone who the primary beneficiaries are absolutely confident will act in their best interests. The advantages of an independent appointor are discussed further at page 95.

Step 4: Assets are transferred to the trusts. D transfers to the A Family Trust a website design business that she has previously established and operated (the business is an active asset). Mr A transfers to the A Investment Trust an investment property and the share portfolio that he and Mrs A have acquired (these are passive assets). In fact, the business and investment assets will be transferred to Busco Pty Ltd and Investco Pty Ltd respectively to hold on the terms of the trusts set out in each of the trust deeds.

There may be CGT, income tax and stamp duty implications on transferring assets in the manner described above. The issue is raised only to illustrate the establishment and operation of discretionary trusts, not to suggest the transfer of assets.



Step 5: The trusts trade. Busco Pty Ltd, as trustee of the A Family Trust, now owns the website design business. Investco Pty Ltd, as trustee of the A Investment Trust, periodically buys and sells shares. From the profit of the share trading, Investco Pty Ltd purchases a holiday home for the A family. The A family uses the home sometimes and at other times rents it to holidaymakers. B marries Z. D continues to be engaged in the website design business, now conducted by Busco Pty Ltd as trustee of the A Family Trust. C goes to university. As at the end of the fifth financial year of its operation, Investco Pty Ltd, as trustee of the A Investment Trust, has assets with a market value of $850,000.



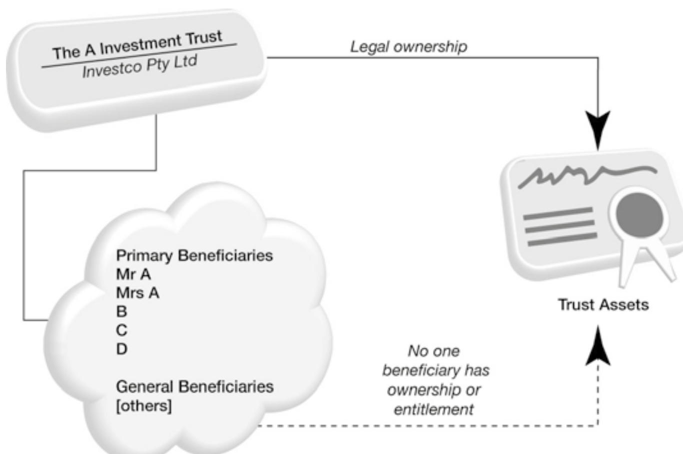
Advantages of a discretionary trust

Advantages	1. Asset protection	The first advantage of a discretionary trust owning assets, or conducting a business, is that no one beneficiary has any claim to the assets of the trust. As a result the trust is the best means of owning assets for the purposes of asset protection. For example, assume a trust owns a business as well as the premises from which that business is conducted. Further suppose that as a result of a speculative investment by a beneficiary, perhaps in property or in shares, the beneficiary encounters financial difficulty. Because the beneficiary does not have any claim to or ownership of the assets of the trust (unless there is money unpaid and owing to him/her by the trust), the creditor of the beneficiary cannot attempt to seize the assets of the trust to satisfy the debt. This would be different if the beneficiary was a shareholder in a company that owned assets in its own right. In this situation, the shares would be available to the beneficiary's creditors. By way of further example, if the beneficiary is involved in Family Court property proceedings, the Family Court cannot direct that the assets of a properly structured trust be used to satisfy the claim of a spouse in the proceedings.
	2. Flexibility in distribution of income	The second advantage of a discretionary trust is that it allows trust income or capital to be distributed between beneficiaries in the most tax effective manner. The trustee is required to distribute the income in each year between the beneficiaries or to accumulate it (although accumulation may result in more tax being paid on that income). The trustee can elect to distribute income to any one of the primary or general beneficiaries, none of whom have any enforceable right to require that any portion of income or fixed sum be paid to them in any year. The trustee has similar power to distribute capital during the life of the trust.
	3. Capital gains tax concessions	The third advantage of conducting a business by way of a trust is that certain taxation advantages arising from the imposition of CGT apply in respect of discretionary trusts. These advantages are unavailable (or available to a lesser extent) to unitholders in a unit trust and shareholders in a company.
	4. Estate planning	Trust property is not owned by any beneficiary and therefore cannot be passed by a beneficiary's will. Control of the trust, and thereby the trust assets, can be passed to the next generation by appropriate consideration of the appointor provisions. For example, the trust deed can provide that, following the death of the original appointors of the trust, their children become the appointors. In that way, the children obtain control of the trust following their parents' death, in much the same way as they would if the assets were passed by will directly on their parents' death. The benefit of the assets being held in a trust is that, if following the death of the original beneficiaries their children are involved in a matrimonial dispute, or encounter financial difficulties leading to bankruptcy, the assets retained in a properly structured trust would not be exposed in the first instance to distribution by the Family Court; in the second instance, the assets would not be exposed to sale and distribution among creditors, as neither the Family Court nor creditors would have title to the trust assets through the exposed children. If funds are required by the children for any specific purpose, the asset can either be acquired by the trust, or a loan can be made by the trust to them (the loan being secured by a mortgage over any asset purchased). A distribution of part of the capital can also be made from the trust.

Advantage 1: asset protection

Family Court proceedings protection

Suppose that B's marriage fails. For the purposes of Family Court property proceedings, B must itemise his assets so that the court can make a division of them between himself and Z. B must list things that he owns or has a legal right to. This includes his car, his computer, his superannuation scheme and so on. B's rights in the trust are discretionary, as the name of the trust indicates. B has no enforceable right to any of the assets or income of the trust. He must list the trust's assets and the Family Court may take them into account for the purpose of apportioning the marriage assets, but the trust's assets cannot be taken from the trust in the proceedings.



Protection of assets in a discretionary trust compared with protection in other structures

This situation should be contrasted with the outcome of other financial arrangements. For example, suppose that B was not a beneficiary of a discretionary trust, but directly held shares in an investment company that owned the assets and generated the income described. B would own the shares in the investment company beneficially (ie for his own benefit) and they would form part of B's property available for distribution under a Family Court order. The following table sets out what would and what would not be protected from a Family Court order.

Arrangement	Protected status
B is a beneficiary in a discretionary trust	B's interest is protected as described above. Strictly speaking, B doesn't have an interest in the income or capital of the trust at all. However, it is important to note that the factual circumstances may be such that the Family Court could deem B to have an interest in the trust. If B was both a beneficiary and had operational control over the trust through the position of trustee, guardian and appointor, the Family Court may consider that those rights and powers under the trust held by B are property for the purposes of s 79 of the *Family Law Act 1975* that has a value equivalent to the value of the assets held by the trust (refer *Kennon v Spry*; *Spry v Kennon* [2008] HCA 56). These issues are explored in greater detail in ¶2-120 of this guide.
B is a unitholder in a unit trust	B's interest is not protected. The assets held by the trustee in the trust would not form part of any division calculations in a family law property settlement, but the units owned by B would. This is because the units give B a right to a certain portion of the income and capital of the trust (according to the number of units he holds and the terms of the trust deed).
B is a shareholder in a company	B's interest is not protected. The assets held by the company would not form part of the division calculations in a family law property settlement, but the shares owned by B would.
B is a beneficiary in a discretionary trust and the trust has made a distribution of income to him	B's interest in the trust itself is protected as described above. B, however, owns outright any income or capital distributed to him (including those amounts not yet paid). The entitlements can be taken into account by the Family Court and are not protected.
B is a beneficiary in a discretionary trust and the trust owes him money	This is similar to the example given immediately above. B has no interest in the assets or income of the trust generally but does to the extent that the trust owes him money (say he lent the trust money or it hasn't yet paid him the amount of a distribution). That money is B's property and is not protected.

Bankruptcy proceedings protection

Another example illustrates the protection offered where a trustee of a discretionary trust conducts a business. Suppose that the website design business continues to do well but that D has, in her own name, borrowed heavily to invest in poorly performing listed shares and she becomes bankrupt when the bank attempts to recoup its loan to her.

Only assets belonging to D can be used to pay her creditors. D does not own the website design business. Busco Pty Ltd owns it. None of the assets which Busco Pty Ltd owns as trustee of the A Business Trust could be used to satisfy the creditors' claims unless:

- Busco Pty Ltd, as trustee of the A Business Trust, had guaranteed the bank's loan to D; or
- the claw-back provisions of the *Bankruptcy Act 1966* could be applied to the original transfer of the website design business to Busco Pty Ltd.

D could continue to work in the business without the business being affected by D's bankruptcy.

The above table would apply to D and to the bankruptcy proceedings in the same way as it applies to B and the Family Court proceedings, except that the reference to the Family Court treating the rights and powers under the trust held by B as property should be compared to the decision of the Federal Court in *Richstar*. This is discussed in more detail in ¶2-120 of this guide.

Advantage 2: flexibility in distribution of income

The A Family Trust has income for the year of $150,000, derived solely from the website design business.

At the end of the fifth year of trading, the A Investment Trust has assets of $850,000. Included in this figure is an amount of $100,000, which represents net income that the A Investment Trust has received throughout that year. The accounts of the A Investment Trust show this income to be made up of:

- $65,000 rent from the investment property; and
- $35,000 rent from the holiday home.

Investco Pty Ltd decides to distribute the income of the fifth year to the primary beneficiaries. It does not distribute to the primary beneficiaries equally; that is, D receives much more income than any other beneficiary. This reflects the fact that rights to the income of the trust (and similarly, to its capital) are discretionary and can be distributed at the sole discretion of Investco Pty Ltd.

Income tax calculations

If Investco Pty Ltd distributes the whole of the net income of the A Investment Trust of $100,000 to C, that amount will be included in C's assessable income. In these circumstances, the trust pays no tax on that income. However, if the trust did not distribute that income in its year of receipt (and was therefore deemed to have accumulated the income) the trustee would have to pay income tax on that amount at the top marginal rate. C, by comparison, as an individual, pays tax on her income at the applicable marginal rates.

Assume that C has no other income for that year. In this example, the trust will pay tax of $45,000 and C will pay tax of $24,947 (calculated at rates applicable for the 2012-13 income year). (Note that the Medicare levy will and a flood levy may also be payable by both the trust and C, in addition to the amounts outlined in the following table.) Issues that arise when determining the income of the trust and the difference between income available for distribution and income for the purposes of taxation law are discussed in chapter 6 of this guide.

Trust's calculations		
Tax rate	x paid on	= tax paid
45%	$100,000	$45,000
		$45,000

C's calculations		
Tax rate	x paid on	= tax paid
0.0%	$18,200	$0
19.0%	$18,800	$3,572
32.5%	$43,000	$13,975
37.0%	$20,000	$7,400
		$24,947

Advantage 3: CGT concessions

As indicated in the key points guide, a discretionary trust may access all of the CGT concessions on the disposal of the business assets. In this respect, a discretionary trust has similar tax treatment to an individual. It is the flow-through nature of the taxation of discretionary trusts that results in this similar treatment.

However, as it is the flow-through nature of the discretionary trust that allows it to access the CGT concessions, the manner in which the amount of the capital gain is distributed must always be considered. For example, should the capital gain be distributed by the discretionary trust to a company, the benefit of the 50% CGT discount would no longer be available.

The benefit is no longer available because, although the 50% CGT discount may be applied at the discretionary trust level, Subdiv 115-C ITAA97 requires that when the amount of the capital gain is distributed to a beneficiary, that beneficiary must then gross-up the amount of the net capital gain to include the amount of the 50% CGT discount. The 50% CGT discount is then subsequently reapplied (after offsetting any capital losses held by the beneficiary). Accordingly, where the amount of the capital gain is distributed to a company, the company will not be able to reapply the 50% CGT discount after the amount of the capital gain is grossed up. Effectively, this achieves a similar result as if the discretionary trust is unable to access the 50% CGT discount in the first instance. Therefore, the amount of the net capital gain will need to be ultimately distributed to natural persons within the same financial year as that in which the CGT event generating the capital gain occurred. If such a distribution is not made, the 50% CGT discount will not be available.

The care that needs to be taken to ensure that the benefit of the 50% CGT discount is obtained previously applied when considering the small business retirement exemption. Although an individual could access the exemption through having the amount of the capital gain deemed to be an eligible termination payment (ETP), a discretionary trust needed to ensure it not only had a controlling individual, but actually paid an ETP. Paying the ETP required the termination of the employment of the CGT concession stakeholder who received the benefit of the small business retirement exemption.

From 1 July 2006, it was no longer necessary for a discretionary trust to actually pay an ETP in order to access the small business retirement exemption; instead the CGT exempt amount was treated as if it was an ETP. The provisions were further amended by the *Superannuation Legislation Amendment (Simplification) Act 2007* with effect from 1 July 2007. The amended provisions removed the reference to ETP and instead operate to treat the payment as being made in consequence of the termination of employment of the CGT concession stakeholder. Further, the range of individuals that may satisfy the definition of CGT concession stakeholder has been expanded. It is no longer necessary to be a controlling individual or a spouse of a controlling individual who receives a distribution from the trust. It is now sufficient to be a significant individual or a spouse of a significant individual who receives a distribution from the trust. The meaning of significant individual is further discussed at ¶3-110 of this guide.

In general terms, in a discretionary trust a significant individual for an income year is one who, when considering both direct and indirect distributions, receives distributions of at least 20% of the income and capital of the trust made in that year, if the trustee of the trust makes such distributions in that year.

Other features of a discretionary trust

Advantages of an independent appointor

Often the primary beneficiaries wholly constitute the appointors. However, providing for an independent appointor (discussed in ¶2-120 and ¶2-125) can have many advantages. The first advantage is that an independent appointor can act as a mediator between appointors in the event that a dispute arises. This, of course, is particularly important when the appointors are not the primary beneficiaries but rather become so as successors to the original appointors.

Some trust deeds provide that, on an appointor being declared bankrupt, the appointor is automatically disqualified from continuing to act as an appointor. The reason for this is the concern that a trustee in bankruptcy may attempt to exercise the power of appointment as an asset of the bankrupt that the trustee in bankruptcy may control. The trustee in bankruptcy may exercise the power of appointment to appoint himself, or his nominee, as trustee of the trust and that new trustee may then realise the assets of the trust and distribute the proceeds to the bankrupt appointor. As those proceeds would be assets coming into the hands of the bankrupt appointor during the period of the bankruptcy, they would be available for distribution by the trustee to the bankrupt's creditors.

To date, this power of appointment has been held by the courts not to be an asset of the bankrupt that is capable of vesting in a trustee in bankruptcy. However, there have been pronouncements by the courts and by the legislature that indicate that, at some time in the future, this particular aspect of the law may change and the power of appointment may fall within the control of the trustee of a bankrupt appointor.

If the deed provides that a person is not entitled to continue to act as an appointor on his bankruptcy, the possibility of the power of appointment being an asset capable of being seized by the trustee in bankruptcy does not arise. However, this scenario illustrates the second advantage of having an independent appointor. For example, if the bankrupts were trustees as well as appointors, the independent appointor, being someone in whom the parties establishing the trust had absolute faith and confidence, could act to replace the bankrupts with a new trustee who was not otherwise linked to them. This would protect the trust assets from seizure in the bankruptcy.

If the trustee is a company in which the bankrupt appointors hold the shares, the trustee in bankruptcy could take those shares and, using the voting rights attaching to the shares, appoint himself and his nominee as directors. These directors could then exercise their powers to realise the trust assets and distribute the proceeds to the bankrupt appointors. The proceeds would then be available for distribution among the bankrupt's creditors. If there was an independent appointor this could not occur because the independent appointor, being the sole remaining appointor (the bankrupts having been excluded), would replace the corporate trustee with an appropriate new trustee.

A third advantage of having an independent appointor arises if the appointors are involved in a Family Court property dispute. This is often relevant where, for example, children of the original appointors become appointors subsequent to their parents' death. This issue is also relevant if there is only one appointor. If two parties are appointors and involved in Family Court proceedings, the Family Court may be able to direct that the appointors act in a certain way, for example, to appoint one of them as trustee. This trustee would then be able to realise the assets of the trust and distribute the proceeds to the parties or in accordance with the Family Court's orders.

A person who is not a party to the marriage cannot currently be subject to Family Court directions unless they hold assets of the marriage. Therefore, if there is an independent appointor, the appointors cannot be directed by the Family Court to exercise the power of appointment in a manner directed by the court. If the deed does not provide that the appointors must act jointly (ie the majority vote prevails) and the appointors are a husband, wife and independent appointor then the court may be able to control the decisions of the appointor by a two to one majority.

Trustee power

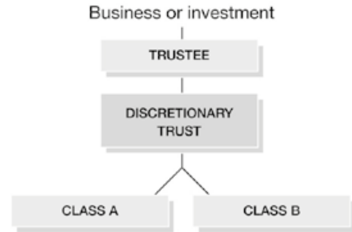
A trustee has a wide range of powers in conducting the affairs of the trust. Some trust deeds provide that a trustee has comprehensive powers enabling it to do everything that a natural person can do. The trustee can:

- buy assets and dispose of them at any time;
- mortgage assets for the purpose of undertaking borrowings, whether for the purposes of the trust or any third party;
- enter into:
  - guarantees;
  - partnerships; or
  - joint ventures; and
- take out policies of insurance on the lives of beneficiaries.

These powers are given by way of example only and are not an exhaustive list

Despite being expressed widely, these powers are designed so that the trustee may generally make any investment, acquire any assets or conduct any business that it, at its sole discretion, determines to be appropriate. In making such an investment, conducting such a business or acquiring such an asset, the trustee can enter into such financing arrangements as it considers appropriate. Further information on trustee powers is provided in ¶1-150 of this guide.

¶3-105 The class discretionary trust

<table>
<tr><td rowspan="9">Key points guide</td><td>Diagram</td><td colspan="2">

Note: A more comprehensive diagram is provided in the detailed guide.</td></tr>
<tr><td>Suggested application</td><td colspan="2">■ To own and operate a business on behalf of multiple families.
■ To hold multiple families’ passive investments (inc shares or property).
■ To hold multiple families’ interest in a partnership business.</td></tr>
<tr><td rowspan="4">Parties</td><td>Who is the legal owner of the assets and makes decisions on a daily basis?</td><td>The trustee</td></tr>
<tr><td>Who owns a beneficial interest in the assets?</td><td>The beneficiaries (but fixed interest only to a class proportionate entitlement)</td></tr>
<tr><td>Who establishes the structure?</td><td>The settlor</td></tr>
<tr><td>Who appoints the legal owner?</td><td>The appointor</td></tr>
<tr><td>Asset protection</td><td colspan="2">■ The structure is protected from claims by creditors of the beneficiaries.
■ Beneficiaries are protected from claims by creditors of the structure.
■ Assets are protected from claims by future spouses of principals and children.
Note: the availability of asset protection is based on the structure itself. Care should always be taken to review loans/entitlements that may exist between the various parties, including personal guarantees that may have been given.</td></tr>
<tr><td>Income taxation</td><td colspan="2">■ Income accumulated by the structure will be taxed at the highest marginal income tax rate plus the Medicare levy.
■ Flow-through taxation applies, so that income distributed by the structure will be taxed in the hands of the recipient at their income tax rate.
■ There is flexibility to distribute income (including income with certain characteristics, eg franked dividends) to any one or more beneficiaries (subject to personal services income and Pt IVA issues) — restricted to the specified percentage for each class.</td></tr>
</table>

Key points guide				
	Capital gains tax concessions		50% discount	✓ Available
		Small business concessions	50% active asset reduction	✓ Available
			15-year exemption	✓ Available (if there is a significant individual[1] throughout a total of 15 years)
			Retirement exemption	✓ Available (if there is a significant individual[1] in year of disposal)
			Roll-over	✓ Available
		Note: the availability of CGT concessions only relates to the availability to the structure. Consideration must be given to the requirements for accessing the concessions outlined in the ITAA97, and the requirement to distribute amounts of net capital gains in some circumstances to avoid the benefit of the concession being eroded by the gross-up rules in Subdiv 115-C ITAA97.		
	Succession planning (estate planning)	■ The assets of the structure are not owned by any one beneficiary and do not form part of a beneficiary's estate on their death. ■ Ultimate control of the trust resides with the appointor. ■ Ultimate control of the structure may be planned by appropriate drafting of the appointor provision.		
	New investors	■ Beneficiaries may be added to the structure. Adding beneficiaries may cause a resettlement with CGT and stamp duty liabilities. ■ The structure is not capitalised by beneficiaries.		

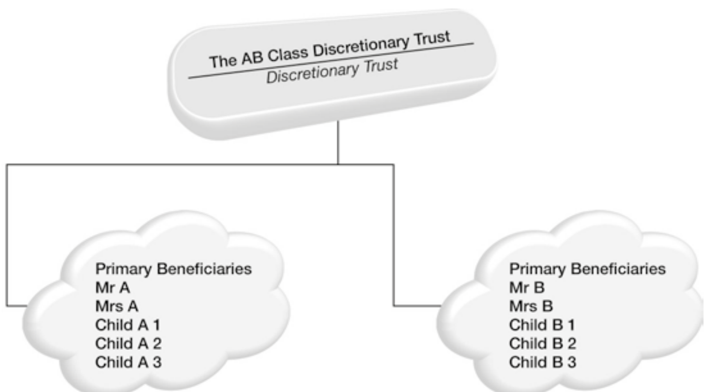
	Other issues	■ Although families' proportionate interests through the classes may be changed, it is difficult to introduce new families into the structure.
		■ There may need to be a family trust election if:
		  ■ a beneficiary is to receive the benefit of franking credits attaching to dividends paid in respect of shares acquired after 31 December 1997; and
		  ■ the beneficiary will have greater than $5,000 in franking credits (in total and from all sources) in the applicable financial year.		

1 A "significant individual" is an individual who has a small business participation percentage[2] in the trust of at least 20% (see s 152-55 ITAA97).

2 The meaning of "small business participation percentage" is outlined in ¶3-110 of this guide.

Detailed guide — the class discretionary trust

This structure is identical to that of the standard discretionary trust except that instead of one class of general beneficiaries to whom the trustee may distribute income, the trust is split such that there are two classes of beneficiaries.



Generally, each family involved in the structure would have its own class of beneficiaries.

Care needs to be taken in adopting such a structure and, in particular, the CGT consequences and family trust election consequences should be analysed.

CGT implications

If the class entitlements were split such that one class had a less than 20% entitlement to distributions of income and capital, the ability of the members of that class to access the small business retirement exemption, among other benefits, would be jeopardised.

The ability to access the small business retirement exemption is put at risk because to access the retirement exemption the trustee of the trust must identify a CGT concession stakeholder. On 1 July 2006, the range of individuals who may satisfy the definition of CGT concession stakeholder was expanded. From that date, it was no longer necessary to be a controlling individual or a spouse of a controlling individual who receives a distribution from the trust. It is now sufficient to be a significant individual or a spouse of a significant individual who receives a distribution from the trust. The meaning of significant individual is further discussed at ¶3-110 of this guide.

In general terms, in a non-fixed (discretionary) trust a significant individual for an income year is one who, when considering both direct and indirect distributions, receives distributions of at least 20% of the income and capital of the trust made in that year if the trustee of the trust makes such distributions in that year. Therefore if one class had less than a 20% entitlement to distributions of income and capital of the trust it would be difficult to identify a member of that class that would satisfy the definition of CGT concession stakeholder. A member of that class may still be a CGT concession stakeholder where the individual:

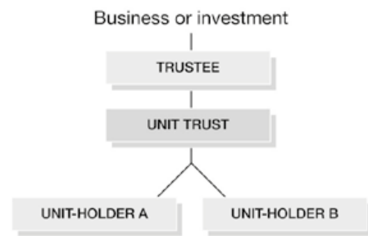
- received distributions from another class in the trust; or
- was the spouse of an individual in another class who received distributions of at least 20% of the income and capital of the trust made in that year, if the trustee of the trust makes such distributions in that year.

Family trust election

The trust may wish to make a family trust election (or interposed entity election) so that it can distribute income to other entities in a group where the family trust election has been made — for example, to enable beneficiaries to claim greater than $5,000 in franking credits.

Although the class discretionary trust may be able to make a family trust election (or interposed entity election), such an election would be required to be limited to one family group, with the result that distributions to other families (even if in respect of their class entitlement) would result in a liability to family trust distribution tax at 46.5%.

¶3-110 The unit trust

<table>
<tr><td rowspan="10">Key points guide</td><td>Diagram</td><td colspan="2">

Note: More comprehensive diagrams are provided in the detailed guide.</td></tr>
<tr><td>Suggested application</td><td colspan="2">■ To own and operate a business on behalf of multiple families.
■ To hold multiple families' passive investments (inc shares or property).
Note: this structure is inappropriate where non-assessable income (save for any 50% CGT discount amount) will be derived.[1]</td></tr>
<tr><td rowspan="4">Parties</td><td>Who is the legal owner of the assets and makes decisions on a daily basis?</td><td>The trustee</td></tr>
<tr><td>Who owns a beneficial interest in the assets?</td><td>The unitholders</td></tr>
<tr><td>Who establishes the structure?</td><td>Unitholders by subscription</td></tr>
<tr><td>Who appoints the legal owner?</td><td>Unitholders by meeting</td></tr>
<tr><td>Asset protection</td><td colspan="2">■ The structure is protected from claims by creditors of those who hold interests in the structure (unitholders) — although a unitholder's interest in the structure may be seized by creditors.
■ Unitholders are protected from claims by creditors of the structure.
Note: the availability of asset protection is based on the structure itself. Care should always be taken to review loans/entitlements that may exist between the various parties, including personal guarantees that may have been given.</td></tr>
<tr><td>Income taxation</td><td colspan="2">■ The trustee will be taxed on income accumulated by the structure at the highest marginal income tax rate plus the Medicare levy under s 99A ITAA36.
■ Flow-through taxation applies, so that income distributed by the structure will be taxed in the hands of the recipient at their income tax rate.
■ There is flexibility to distribute income (including income with certain characteristics, eg franked dividends) to unitholders (subject to personal services income and Pt IVA issues). Distribution to unitholders must be in accordance with the unit's right to income.</td></tr>
</table>

Key points guide			
Capital gains tax concessions to the structure		50% discount	✓ Available
	Small business concessions	50% active asset reduction	✓ Available (but the benefit is reduced by capital gains tax event E4)[1]
		15-year exemption	✓ Available (if there is a significant individual[2] throughout a total of 15 years)
		Retirement exemption	✓ Available (if there is a significant individual[2] in year of disposal)
		Roll-over	✓ Available
Capital gains tax concessions to unitholders		50% discount	✓ Available
	Small business concessions	50% active asset reduction	✓ Available
		15-year exemption	✓ Available (note the test period)
		Retirement exemption	✓ Available
		Roll-over	✓ Available
		Note: small business CGT concessions are only available to a unitholder that is: 1. an individual who is a CGT concession stakeholder[3] in the unit trust; or 2. an entity in which CGT concession stakeholders[3] of the unit trust have an aggregate small business participation percentage[4] of 90%.	
	Note: the availability of CGT concessions only relates to the availability to the structure. Consideration must be given to the requirements for accessing the concessions outlined in the ITAA97, and the requirement to distribute amounts of net capital gains in some circumstances to avoid the benefit of the concession being eroded by the gross-up rules in Subdiv 115-C ITAA97.		
Succession planning (estate planning)	■ The assets of the structure are not owned by any one unitholder and do not form part of an individual unitholder's estate on their death — although the units, if held personally, would form part of that individual's estate. ■ Ultimate control of the trust resides with the unitholders who, by resolution at a meeting, may remove and appoint trustees. Consideration should be given to which individual(s) or entity(ies) should hold the units.		
New investors	■ May apply for new units in the structure to which they will contribute funds (the structure is to use those funds for its activities). ■ May purchase units from existing unitholders.		

Key points guide		

	Other issues	■ This structure is not appropriate if non-assessable income (save for any 50% CGT discount amount) will be derived.[1]
		■ Interest on borrowings to acquire units may be deductible.[5]
		■ This structure is not appropriate where revenue losses are involved (a fixed unit trust should be used instead).
		■ There may need to be a family trust election if:
		  ▪ a beneficiary is to receive the benefit of franking credits attaching to dividends paid in respect of shares acquired after 31 December 1997; and
		  ▪ the beneficiary will have greater than $5,000 in franking credits (in total and from all sources) in the applicable financial year.

1 Refer to "The CGT event E4 problem" in ¶7-105.

2 A "significant individual" is an individual who has a small business participation percentage[4] in the trust of at least 20% (see s 152-55 ITAA97).

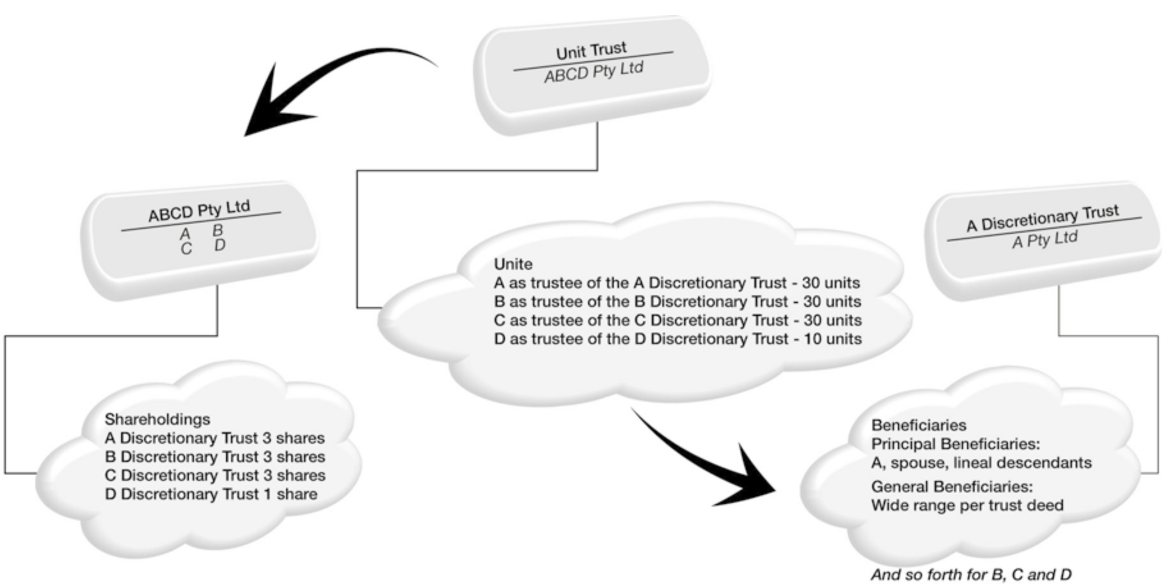
3 A "CGT concession stakeholder" is a significant individual[2] of the trust or a spouse of the significant individual,[2] if the spouse has a small business participation percentage at that time greater than zero (see s 152-60 ITAA97).

4 The meaning of "small business participation percentage" is outlined in ¶3-110 of this guide.

5 Refer to "Tax deductibility of interest incurred to acquire an interest in a trust" in ¶7-145 of this guide.

Detailed guide — the unit trust

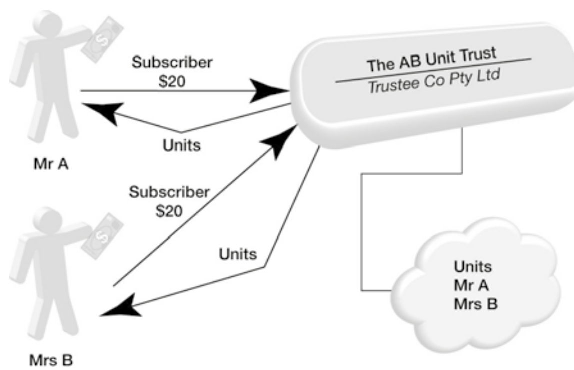
A unit trust is a trust in which the entitlement of the beneficiaries is divided into units. The amount of a beneficiary's entitlement to income or capital of the unit trust is determined by the number of units held.



The trustee distributes income and capital to the unitholders in proportion to the number of units each beneficiary holds.

In this respect, a unit trust is described as being “fixed” and is distinguished from a discretionary trust in which the trustee can distribute the income and capital between the beneficiaries, or only some of them, in the proportions the trustee sees fit.

Although a unit trust can be established by settlement (ie using a settlor in the same manner as a discretionary trust) it is generally established by subscription. This involves the subscribers (who are the initial unitholders) paying funds to the trustee in exchange for the issue to them of units in the trust, in a manner similar to shareholders subscribing for shares when a company is incorporated.



With a unit trust by subscription, there are accordingly two parties: the trustee and the subscribers or initial unitholders.

Some unit trusts provide for different classes of units that have different rights attaching to them but this guide deals with the usual form of unit trust — where there is just one class of units. Units can also be issued as partly paid but the more common situation is that units are fully paid on being issued.

The assets of the unit trust (the trust fund) are held by the trustee on trust for the unitholders, who are entitled to the capital and income in proportion to their holding of units. A unit is really just a means of describing the share in the trust fund to which the unitholder is entitled.

Features

The trustee has a right of indemnity against the trust fund for any liability the trustee incurs in acting as trustee of the unit trust, provided that the trustee has acted in good faith and within its powers. The trustee does not have any right of indemnity against the unitholders personally.

Although each unitholder is entitled to its share of the income and capital, generally a unitholder cannot call for a particular asset which forms part of the trust fund to be distributed to that unitholder, and is not entitled to a distribution of any part of the capital, unless the trustee determines to make an interim distribution of capital or the unit trust is wound up.

The trustee may issue new units that usually must be issued at market value or at some "fair" value determined in accordance with a methodology outlined in the trust deed. Generally, units must be offered first pro rata to existing unitholders before being offered to others. However, the trust deed will usually provide that new units may be offered to others and on different terms if there has been a unanimous resolution of unitholders to that effect.

Unitholders may transfer their units but if they wish to transfer the units to someone other than a related party (or a party entitled to the units as a result of the death of the unitholder), the trust deed will usually state that the units must first be offered to other unitholders on a pro rata basis and at market value or the price being offered by the third party before being transferred elsewhere. Again, it is common for the trust deed to allow this procedure to be amended by a unanimous resolution of unitholders.

Unit trusts often contain provisions that allow a unitholder to request that the trustee repurchase (redeem) some or all of the unitholder's units. Generally the repurchase occurs after the receipt of a request at the discretion of the trustee and on the condition that the trustee agrees that the units are repurchased at market value — unless there is a unanimous resolution of unitholders permitting the units to be redeemed on a different basis.

Similar to a discretionary trust, trustees often have a wide range of investment powers and management powers in relation to the trust fund.

The trust deed should contain detailed provisions for the calling and conduct of meetings of unitholders and outline their voting entitlement (usually one vote per fully paid unit). Typically, a special resolution of unitholders is required to change the trustee.

Most standard unit trust deeds will provide that unitholders are entitled to:

- receive that proportion of assessable income of the trust equal to the proportion of units held;
- one vote per unit held; and
- receive a proportion of the capital of the trust equal to the proportion of units held.

Not all unit trust deeds will have the features described above. Some unit trust deeds may differ from that outlined above merely by the number of votes required to pass a resolution.

Unit trust compared with a company

The execution of a unit trust deed establishes a relationship between a trustee and beneficiaries. In this relationship the trustee holds property on trust for various unitholder beneficiaries who have a beneficial interest in the assets of the trust proportionate to their unitholding.

A unit trust with unitholders differs from a company with shareholders in a number of respects:

- A company is a separate legal entity that can sue and be sued, while a unit trust is not a separate legal entity and cannot be sued directly. If any action is taken against the trust, it is the trustee that is sued and it is the trustee that incurs and bears the liabilities of the unit trust.

- Shareholders in a company have no legal title to or beneficial interest in the assets of the company. Rather, their legal title is in regard to the shares that they own. Legal and beneficial title in the company's assets rests with the company as a separate legal entity. Unitholders, on the other hand, have an equitable proprietary interest in all the assets of the trust *(Charles v FCT* (1954) 90 CLR 598 at 609). However, this is not to say that unitholders in the unit trust have a proprietary interest in each of its assets (*Livingston v Commissioner of Stamp Duties (Qld)* (1960) 107 CLR 411 at 438).
- Capital profit distributions to unitholders by the trustee retain the nature of a capital receipt in the hands of the unitholders, while a similar distribution from a company (prior to liquidation or winding up) is likely to be a dividend and assessable income in the hands of the shareholder — even though it may have been capital in the hands of the distributing company.

Distributions from the unit trust

As indicated earlier, the nature of capital or income payments by a trustee to unitholders will be preserved in the hands of the unitholder to whom the distributions are made. This does not cause a problem in regard to income distributions made by the trustee. However, certain capital payments by the trustee to unitholders may result in cost base adjustments to the units held by certain unitholders and, in some instances, may trigger a deemed capital gain.

If the trustee incurs a capital gain in respect of a disposal of any of its investments, it may be eligible to claim the 50% CGT discount, and some or all of the small business CGT concessions.

If, after claiming the 50% CGT discount and any other available concessions, the unit trust has a net capital gain, the amount of the net capital gain will need to be ultimately distributed to natural persons within the same financial year as that in which the CGT event generating the capital gain occurred. If such a distribution is not made, the 50% CGT discount will not be available to the unit trust and the corresponding capital gain will be grossed up to their pre-concession value. Furthermore, the trustee will be liable to pay tax on the grossed up capital gain at the highest marginal tax rate. Distributions may be made through a chain of trusts to a natural person.

The payment of the income of the unit trust (after claiming the 50% CGT discount) will not result in any cost base adjustments. Where payment of the net capital gain (after application of the 50% CGT discount) is made to a company, the amount of the non-assessable distribution will need to be grossed up because a company is not eligible to claim the 50% CGT discount. Effectively the company will be taxed on the amount of the capital gain without the benefit of the 50% CGT discount.

The cost base adjustment rules will *not* apply to any payment of a non-assessable amount representing the 50% CGT discount in respect of the interests held by unitholders in the unit trust to those unitholders. However:

- The cost base adjustment rules do apply to payments of non-assessable amounts to unitholders to the extent that the non-assessable amount includes the small business 50% active asset reduction.
- The payment of the amount of the small business 50% active asset reduction to unitholders will trigger CGT event E4 and reduce the cost base of the units. Where the amount of the small business 50% active asset reduction exceeds the amount of the cost base of the units, the excess will constitute a capital gain to the affected unitholder.
- Further detail of the CGT event E4 problem is outlined in ¶7-105 of this guide.

Disposal of units

Prior to 1 July 2006, it was not possible for entities to use the small business CGT concessions to reduce the CGT payable on CGT events relating to shares held in companies or interests held in trusts (underlying interests). The relevant taxpayer had to be an individual.

Amendments to the small business CGT concessions introduced on 7 December 2006 in the Tax Laws Amendment (2006 Measures No. 7) Bill 2006 (the Bill) and passed by parliament on 28 March 2007 repealed s 152-10(2) ITAA97 and substituted a new provision that allows entities holding underlying interests in a company or trust to access the small business CGT concessions in certain circumstances. The amendment has effect from 1 July 2006 and is a significant change to the operation of the concessions.

The previous test

Access to the concessions by entities holding underlying interests was denied by the operation of s 152-10(2) ITAA97. That subsection provided that, where the relevant CGT asset was a share in a company or an interest in a trust, an additional threshold test had to be satisfied to allow access to the small business CGT concessions.

The first limb of that additional test required that the entity in which the underlying interest was held had to satisfy the controlling individual test. An entity satisfied the controlling individual test if the entity had a least one controlling individual just before the CGT event. Unravelling the defined terms further, a controlling individual in respect of a trust was an individual entitled to 50% of the income and capital of a fixed trust or 50% of the distributions of income and capital made in the relevant year by a non-fixed trust. A controlling individual of a company was an individual with entitlements to 50% of the voting rights, to 50% of any dividends declared by the company and to 50% of any distributions of capital made by the company. Therefore, although the entity holding the underlying interest could not itself be a controlling individual, the first limb of the test could be satisfied so long as the company or trust in which the underlying interest was held had a controlling individual.

The problem for entities resulted from the second limb of the test. The second limb required that the taxpayer itself be a “CGT concession stakeholder” in the relevant company or trust. A CGT concession stakeholder was defined as a controlling individual or the spouse of a controlling individual who also held an interest in the entity. As noted above, a controlling individual by definition could only be a natural person individual. As such, entities holding underlying interests could not access the small business CGT concessions when selling those underlying interests. This created difficulties where taxpayers had chosen to structure themselves with a unitised trust structure or a company with interests held by trusts. Selling those units or shares to third parties or among the equity holders triggered a liability to CGT that could only be reduced by the general discount CGT concession in Div 115 and not the small business CGT concessions.

Taxpayers adopted a variety of means of addressing this issue. Such measures included the use of partnerships of trusts or hybrid trusts where taxpayers attempted to balance wealth protection, flexibility of income distribution, administrative ease and access to CGT concessions in making their structuring decisions. While the amendment allowing entities holding underlying interests to access the small business CGT concessions does not provide one easy solution to the structuring decision, it does assist in reducing the importance of one of those hurdles to the decision of what is an appropriate structure for a given investment or trading activity.

How does the new test operate?

The new test operates by replacing the previous two limb test with two tests which operate in the alternative. The first test is effectively a continuation of the previous test and simply requires that the taxpayer holding the underlying interest be a CGT concession stakeholder in the relevant company or trust. As with the previous test, that provision requires the taxpayer to be a natural person individual.

The second test is new. It states in s 152-10(2) ITAA97:

> *(2) If the CGT asset is a share in a company or an interest in a trust (the object company or trust), one of these additional basic conditions must be satisfied just before the CGT event.*
>
> *(a) …*
>
> *(b) CGT concession stakeholders in the object company or trust together have a small business participation percentage in you of at least 90%.*

Although still referring to CGT concession stakeholders, the test no longer requires those individuals to hold the underlying interest personally. The test can be satisfied where an entity holds the direct underlying interest in the relevant entity and those CGT concession stakeholders hold what is defined as a "small business participation percentage" of at least 90% in the entity holding the underlying interest. By including the reference to CGT concession stakeholders, the new test practically still has two limbs that must be satisfied.

First limb

The first limb involves identifying a CGT concession stakeholder in the object company or trust. As noted above, under the previous test this referred to a controlling individual or a spouse of a controlling individual and required those individuals to hold a direct interest in the object company or trust.

The new test includes amendments to the definition of CGT concession stakeholder. The new test defines a CGT concession stakeholder by reference to a "significant individual" rather than a controlling individual.

A "significant individual" is an individual that has "small business participation percentage" in the company or trust of at least 20%.

Again, unravelling the definitions further, a small business participation percentage is defined as the combination of an individual's direct and indirect participation percentages in the relevant entity. Those participation percentages are effectively the extent to which the individual participates, directly and indirectly, in the income or capital of a trust or voting power, dividends or distributions of capital from a company.

Where the percentages differ in relation to those various categories of entitlement in the one entity then it is the smallest percentage that applies. For non-fixed trusts such as the hybrid trust and discretionary trusts, it is only where the trust makes a distribution of income or capital in the relevant year that the percentage of that distribution received by the individual (as compared to all distributions of that amount made) that is to be included in the calculations. For example, if a hybrid trust does not distribute any capital, but does distribute \$100 in income to which an individual is directly and/or indirectly beneficially entitled to \$20, that individual would have a participation percentage of 20%. Alternatively, if in addition to the income distribution the trust distributed \$100 in capital to which the individual is directly and/or indirectly beneficially entitled to \$10, the individual would have a participation percentage of 10% (the smaller of the two potential participation percentages).

In a trust where entities have entitlements to all of the income and capital of the trust (a fixed trust such as a unit trust), an individual's small business participation percentage is determined by the smallest of the individual's:

- percentage entitlement to any distribution of income that the trust may make; or
- percentage entitlement to any distribution of capital that the trust may make.

In a company, an individual's small business participation percentage is determined by the smallest of the individual's:

- percentage voting power in the company;
- percentage entitlement to any dividends that the company may pay; or
- percentage entitlement to any distribution of capital that the company may make.

Therefore, because the new significant individual test operates on an indirect and direct basis, it is no longer necessary for the individual to hold the underlying interest in the object company or trust in order to be defined as a CGT concession stakeholder of that entity. In summary, the first limb requires the identification of individuals who ultimately hold a small business participation percentage of at least 20%.

Second limb

The second limb relies on those individuals defined as CGT concession stakeholders of the object company or trust having a significantly strong connection to the entity holding the direct underlying interest. The strength of that connection is again determined using the same small business participation percentage as outlined above in relation to the first limb. However, in relation to this second limb of the test the individual CGT concession stakeholders of the object company or trust must collectively hold a participation percentage of at least 90% in the entity with the underlying interest in order for the test to be passed.

Combination of the two limbs

The operation of the two limbs of the new subpara 152-10(2)(b) ITAA97 requires the identification of an individual or individuals who each hold a small business participation percentage of at least 20% in the object company or trust, and who collectively hold a small business participation percentage of at least 90% in the entity with the underlying interest.

Example 1

Assume a small business is operated by a unit trust with two unitholders (A and B). Each of those unitholders is a discretionary trust. Assume unitholder A wishes to sell their units to unitholder B. For unitholder A to be able to apply the small business CGT concessions when reducing any taxable capital gain on the sale of the units, unitholder A could ensure that 90% of any distributions of income or capital made in the year of the CGT event are distributed to an individual. In addition to the small business participation percentage of 90% in unitholder A, that individual would have a small business participation percentage of 45% in the object unit trust (unitholder A's 50% interest multiplied by the extent to which the individual is beneficially entitled to distributions made by unitholder A — 90%).

Example 2

As described above, the small business participation percentage of at least 90% in the trust holding the underlying interest may be satisfied by aggregating the small business participation percentage of a number of CGT concession stakeholders. Assume the same facts as outlined in example 1 save that of the distributions of income or capital made by unitholder A in the year of the CGT event, 50% are to individual X and 50% are to individual Y.

In that case, both limbs of the test are still satisfied. Each of X and Y are CGT concession stakeholders as each have small business participation percentages of 25% in the object unit trust (unitholder A's 50% interest multiplied by the extent to which each individual is beneficially entitled to distributions made by unitholder A — 50%). As the CGT concessions stakeholders in the object unit trust collectively have a 100% small business participation percentage in unitholder A, the 90% threshold test is satisfied.

Example 3

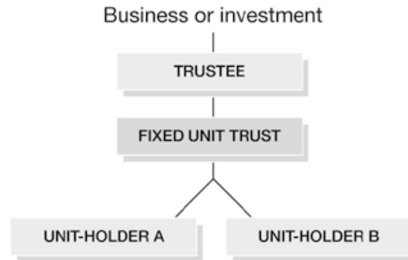
Assume that there are five equal unitholders in the unit trust (A to E) and unitholder A ensures that 90% of any distributions of income or capital made in the year of the CGT event are distributed to an individual. In this case the test would not be satisfied. Although the individual has a small business participation percentage of 90% in unitholder A, that individual only has a small business participation percentage of 18% in the object unit trust (unitholder A's 20% interest multiplied by the extent to which the individual is beneficially entitled to distributions made by unitholder A — 90%). In this example, the individual is not a CGT concession stakeholder as the individual does not hold the requisite 20% significant interest.

If, instead of 90% of any distributions of income or capital made in the year of the CGT event being distributed to the individual, unitholder A ensured that 100% of distributions were made to the individual, then the individual would be a CGT concession stakeholder of the object unit trust (20% multiplied by 100%), in turn satisfying the first limb of the new threshold test.

Further threshold tests for the small business CGT concessions

It is important to note that the above analysis considers only one of the threshold tests. The remainder of the threshold tests in addition to the tests applicable to each of the four individual small business CGT concessions still need to be satisfied in each case.

¶3-115 The fixed unit trust

Key points guide	Diagram	 Note: A more comprehensive diagram is provided in the detailed guide.	
	Suggested application	Where access to income tax deductions from revenue losses is important: ■ to own and operate a business on behalf of multiple families; ■ to hold multiple families' passive investments (inc shares or property). Note: this structure is inappropriate where non-assessable income (save for any 50% CGT discount amount) will be derived.[1]	
	Parties	Who is the legal owner of the assets and makes decisions on a daily basis?	The trustee
		Who owns a beneficial interest in the assets?	Unitholders
		Who establishes the structure?	Unitholders by subscription
		Who appoints the legal owner?	Unitholders by meeting
	Asset protection	■ The structure is protected from claims by creditors of those who hold interests in the structure (unitholders) — although the unitholder's interest in the structure may be seized by those creditors. ■ Unitholders are protected from claims by creditors of the structure. Note: the availability of asset protection is based on the structure itself. Care should always be taken to review loans/entitlements that may exist between the various parties, including personal guarantees that may have been given.	
	Income taxation	■ Income accumulated by the structure will be taxed at the highest marginal income tax rate plus the Medicare levy. ■ Flow-through taxation applies, so that income distributed by the structure will be taxed in the hands of the recipient at their income tax rate. ■ There is flexibility to distribute income (including income with certain characteristics, eg franked dividends) to any one or more beneficiaries (subject to personal services income and Pt IVA issues) — restricted to the specified percentage for each class.	

Key points guide	Capital gains tax concessions to the structure		50% discount	✓ Available
		Small business concessions	50% active asset reduction	✓ Available
			15-year exemption	✓ Available (if there is a significant individual[2] throughout a total of 15 years)
			Retirement exemption	✓ Available (if there is a significant individual[2] in year of disposal)
			Roll-over	✓ Available
	Capital gains tax concessions to unitholders	Small business conessions	50% discount	✓ Available
			50% active asset reduction	✓ Available
			15-year exemption	✓ Available (note the test period)
			Retirement exemption	✓ Available
			Roll-over	✓ Available
			Note: small business CGT concessions are only available to a unitholder that is: 1. an individual who is a CGT concession stakeholder[3] in the fixed unit trust; or 2. an entity in which CGT concession stakeholders[3] of the fixed unit trust have an aggregate small business participation percentage[4] of 90%.	
		Note: the availability of CGT concessions only relates to the availability to the structure. Consideration must be given to the requirements for accessing the concessions outlined in the ITAA97, and the requirement to distribute amounts of net capital gains in some circumstances to avoid the benefit of the concession being eroded by the gross-up rules in Subdiv 115-C ITAA97.		
	Succession planning (estate planning)	■ The assets of the structure are not owned by any one unitholder and do not form part of an individual unitholder's estate on their death — although the units would form part of that estate. ■ Ultimate control of the trust resides with the unitholders who, by resolution at a meeting, may remove and appoint trustees. Consideration should be given to which individual(s) or entity(ies) should hold the units.		

Key points guide	New investors	■ May apply for new units in the structure for which they will contribute funds, where the structure will use those funds for its activities. ■ May purchase units from existing unitholders.
	Other issues	■ Not appropriate if non-assessable income (save for the CGT 50% discount amount) will be derived. ■ Interest on borrowings to acquire units may be deductible.[5] ■ Appropriate where revenue losses are involved. ■ The fixed unit trust differs from an ordinary unit trust in that the provisions dealing with the issue and redemption of units by the trustee provide that each of those must occur at a price determined on the basis of the net asset value of the trust fund, according to Australian accounting principles. ■ The power of amendment in the deed is also restricted so that the provisions regarding the calculation of the price for the issue or redemption of units cannot be altered.

1 Refer to "The CGT event E4 problem" in ¶7-105 of this guide.

2 A "significant individual" is an individual who has a small business participation percentage[4] in the trust of at least 20% (see s 152-55 ITAA97).

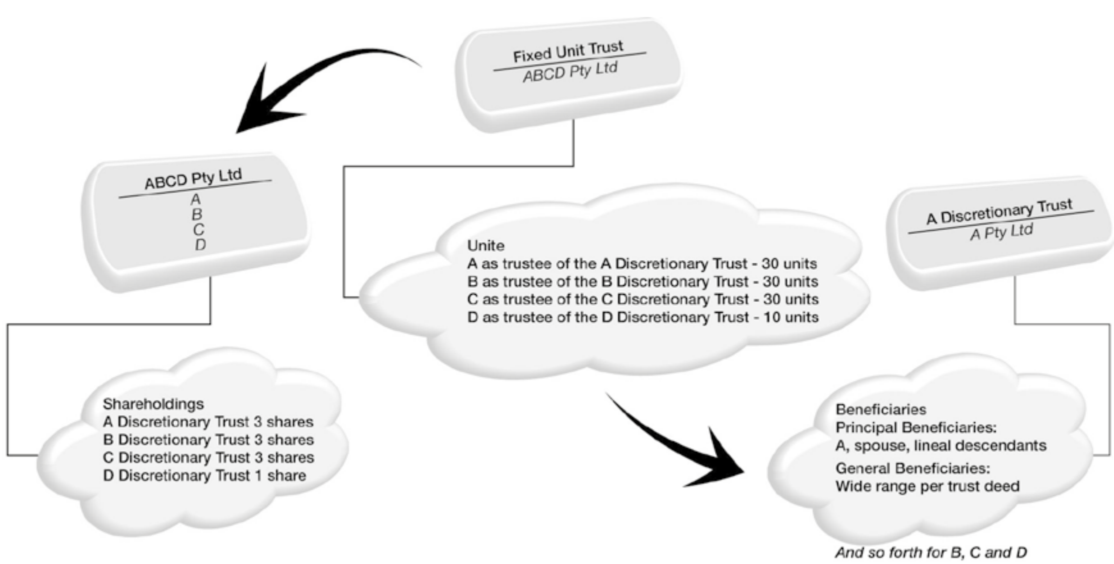
3 A "CGT concession stakeholder" is a significant individual[2] of the trust or a spouse of the significant individual,[2] if the spouse has a small business participation percentage at that time greater than zero (see s 152-60 ITAA97).

4 The meaning of "small business participation percentage" is outlined in ¶3-110 of this guide.

5 Refer to "Tax deductibility of interest incurred to acquire an interest in a trust" in ¶7-145 of this guide.

Detailed guide — the fixed unit trust

A fixed unit trust is a unit trust drafted to satisfy the requirements to be a "fixed trust" under the trust loss provisions in Sch 2F ITAA36.



For a unit trust to be a "fixed trust" for these purposes, the unitholders must have a fixed entitlement to a share of the income or capital of the trust. To satisfy this requirement, any issue of further units or redemption of units by the trustee must occur at a price determined on the basis of the net asset value of the trust fund according to Australian accounting principles. Any other method of valuation will mean that the trust is a non-fixed trust.

If a trust is a non-fixed trust for the purpose of the trust loss provisions, it will effectively have to satisfy a pattern of distributions test to enable it to carry forward losses to later years of income. The pattern of distributions test requires that more than 50% of the income distributions in the relevant years (which may be as many as six years) are distributed to the same individuals.

As a fixed trust the primary test to be satisfied is the "50% stake test", which requires that the same individuals have fixed entitlements to more than 50% of the income and capital of the trust at the relevant times. This would normally be a much easier test to satisfy than the pattern of distributions test.

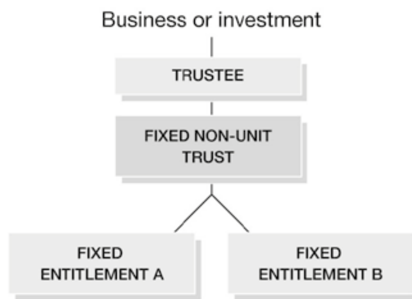
It should be noted that, if the units in a fixed trust are themselves held by the trustees of a non-fixed trust (eg a discretionary trust in respect of which a family trust election has not been made), then each of the non-fixed trust unitholders will need to satisfy the pattern of distributions test.

The trust loss provisions are complex. These comments are intended as a general explanation of the purpose of the fixed unit trust and should not be taken as detailed advice regarding the workings of the trust loss provisions.

The fixed unit trust differs from an ordinary unit trust in that the provisions dealing with the issue of further units and the redemption of units by the trustee provide that each of these must occur at a price determined on the basis of the net asset value of the trust fund according to Australian accounting principles. The power of amendment in the deed is also restricted so that the provisions regarding the calculation of the price for the issue or redemption of units cannot be altered.

¶3-120 The fixed non-unit trust

Key points guide

Diagram	 Note: A more comprehensive diagram is provided in the detailed guide.	
Suggested application	■ To own and operate a business on behalf of multiple families. ■ To hold multiple families' passive investments (inc shares or property). Note: this structure is appropriate for the suggested applications identified above where non-assessable income will be derived and the proportionate entitlement of the parties is not expected to change.	
Parties	Who is the legal owner of the assets and makes decisions on a daily basis?	The trustee
	Who owns a beneficial interest in the assets?	The fixed entitlement holders
	Who establishes the structure?	The settlor
	Who appoints the legal owner?	The fixed entitlement holders
Asset protection	■ The structure is protected from claims by creditors of those who hold interests in the structure (fixed entitlement holders) — although creditors may seize the fixed entitlement in the structure. ■ Fixed entitlement holders are protected from claims by creditors of the structure. Note: the availability of asset protection is based on the structure itself. Care should always be taken to review loans/entitlements that may exist between the various parties, including personal guarantees that may have been given.	
Income taxation	■ Income accumulated by the structure will be taxed at the highest marginal income tax rate plus the Medicare levy. ■ Flow-through taxation applies, so that income distributed by the structure will be taxed in the hands of the recipient at their income tax rate. ■ There is flexibility to distribute income (including income with certain characteristics, eg franked dividends) to fixed entitlement holders (subject to personal services income and Pt IVA issues); distribution to fixed entitlement holders must be in accordance with the fixed entitlement's right to income.	

<table>
<tr><td rowspan="13">Key points guide</td><td rowspan="5">Capital gains tax concessions to the structure</td><td colspan="2">50% discount</td><td>✓ Available</td></tr>
<tr><td rowspan="4">Small business concessions</td><td>50% active asset reduction</td><td>✓ Available (see other issues below)</td></tr>
<tr><td>15-year exemption</td><td>✓ Available (if there is a significant individual[2] throughout a total of 15 years)</td></tr>
<tr><td>Retirement exemption</td><td>✓ Available (if there is a significant individual[2] in year of disposal)</td></tr>
<tr><td>Roll-over</td><td>✓ Available</td></tr>
<tr><td rowspan="6">Capital gains tax concessions to fixed entitlement holders</td><td colspan="2">50% discount</td><td>✓ Available</td></tr>
<tr><td rowspan="5">Small business concessions</td><td>50% active asset reduction</td><td>✓ Available</td></tr>
<tr><td>15-year exemption</td><td>✓ Available (note the test period)</td></tr>
<tr><td>Retirement exemption</td><td>✓ Available</td></tr>
<tr><td>Roll-over</td><td>✓ Available</td></tr>
<tr><td colspan="2">Note: small business CGT concessions are only available to a fixed entitlement holder that is:
1. an individual who is a CGT concession stakeholder[3] in the fixed non-unit trust; or
2. an entity in which CGT concession stakeholders[3] of the fixed non-unit trust have an aggregate small business participation percentage[4] of 90%.</td></tr>
<tr><td></td><td colspan="3">Note: the availability of CGT concessions only relates to the availability to the structure. Consideration must be given to the requirements for accessing the concessions outlined in the ITAA97, and the requirement to distribute amounts of net capital gains in some circumstances to avoid the benefit of the concession being eroded by the gross-up rules in Subdiv 115-C ITAA97.</td></tr>
<tr><td>Succession planning (estate planning)</td><td colspan="3">■ The assets of the structure are not owned by any one fixed entitlement holder and do not form part of an individual fixed entitlement holder’s estate on their death — although the fixed entitlements would form part of that estate.
■ Ultimate control of the trust resides with the fixed entitlement holders who, by resolution at a meeting, may remove and appoint trustees. Consideration should be given to which individual(s) or entity(ies) should hold the fixed entitlements.</td></tr>
</table>

Key points guide		
	New investors	■ Where the structure needs further funds (eg to purchase new plant or equipment) new investors may apply for new fixed entitlements in the structure for which they will contribute funds. ■ New investors may also purchase fixed entitlements from existing holders.
	Other issues	■ Interest on borrowings to acquire fixed entitlements may be deductible.[5] ■ Where the fixed entitlement holder acquired its interest for no expenditure (ie on establishment), CGT event E7 would apply (on a distribution of non-assessable amounts to that fixed entitlement holder) and the cost base adjustment CGT event E4 would not apply.[1] ■ CGT event E4 would occur if non-assessable amounts were to be distributed to a fixed entitlement holder that paid an amount to acquire its interest.[1]

1 Refer to "The CGT event E4 problem" in ¶7-105.

2 A "significant individual" is an individual who has a small business participation percentage[4] in the trust of at least 20% (see s 152-55 ITAA97).

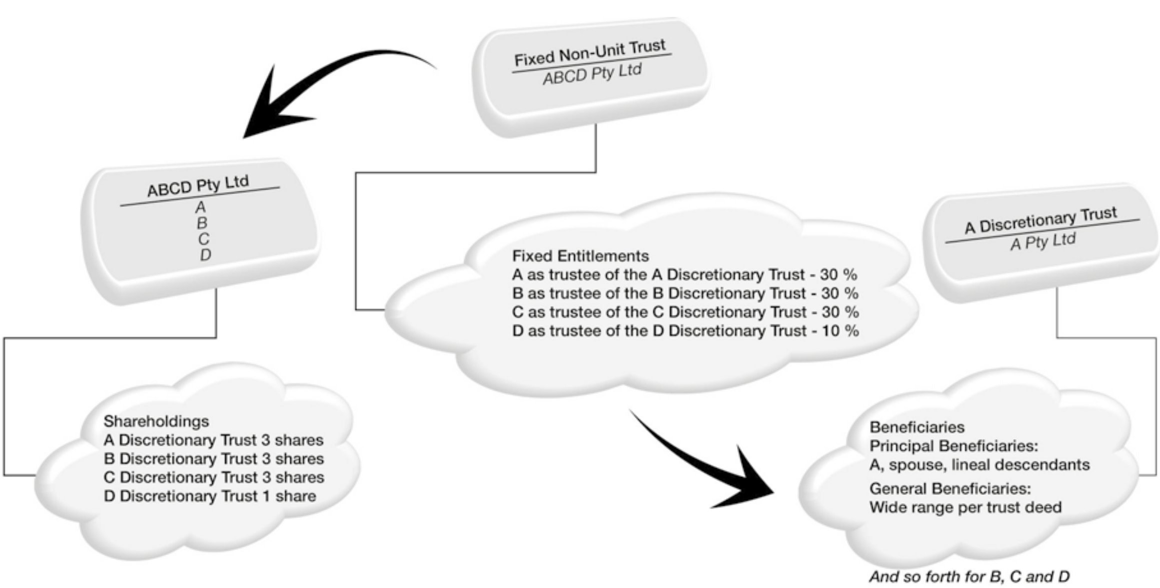
3 A "CGT concession stakeholder" is a significant individual[2] of the trust or a spouse of the significant individual,[2] if the spouse has a small business participation percentage at that time greater than zero (see s 152-60 ITAA97).

4 The meaning of "small business participation percentage" is outlined in ¶3-110 of this guide.

5 Refer to "Tax deductibility of interest incurred to acquire an interest in a trust" in ¶7-145 of this guide.

Detailed guide — the fixed non-unit trust

The fixed non-unit trust is a fixed trust in which the beneficiaries' entitlements are determined simply by percentage and not by units. In essence, it is a unit trust without units. A settlor gives money to a trustee who holds the money on trust for the beneficiaries (fixed entitlement holders) according to their determined share.



Beneficiaries are divided into multiple classes: income beneficiaries and capital beneficiaries (although the one person can be, and usually is, a beneficiary of each class).

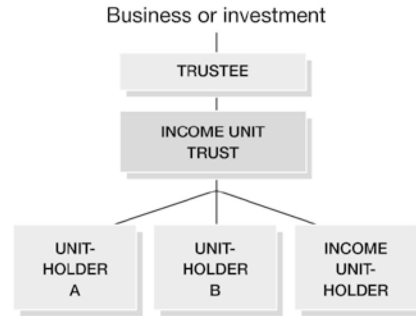
A beneficiary has an entitlement that is fixed although that entitlement can change with the agreement of all the beneficiaries of that class.

The trust is not discretionary and, consequently, would not be useful in circumstances in which asset protection is a reason for the establishment of the trust. It is designed to enable the small business 50% active asset reduction to be passed through to trust beneficiaries.

Where the gain to which the reduction is sought to be applied is distributed to beneficiaries who are not unitholders and who have not paid anything for their interest in the trust, the reduction will pass through to the beneficiaries without the application of the cost base adjustment rules due to the more specific event — CGT event E7 (disposal to beneficiary to end capital interest) — applying in this instance. If any part of the fixed interest of the fixed entitlement holder was acquired for a payment, the more specific event would be CGT event E4 and the CGT consequences of the cost base adjustment rules (see ¶7-105 of this guide) would apply.

¶3-125 The income unit trust

Key points guide

Diagram	 Note: A more comprehensive diagram is provided in the detailed guide.		
Suggested application	■ To own and operate a business on behalf of multiple families. ■ To hold multiple families' passive investments (inc shares or property). ■ To provide a key employee (or associate) the opportunity to receive income from the structure (at the trustee's discretion) without providing any voting or capital rights through the issue of income units. Note: this structure is inappropriate where non-assessable income (save for any 50% CGT discount amount) will be derived.[1]		
Parties	Who is the legal owner of the assets and makes decisions on a daily basis?	The trustee	
	Who owns a beneficial interest in the assets?	Unitholders	
	Who establishes the structure?	Unitholders by subscription	
	Who appoints the legal owner?	Unitholders by meeting	
Asset protection	■ The structure is protected from claims by creditors of those who hold interest in the structure (unitholders) — although a unitholder's interest in the structure may be seized by creditors. ■ Unitholders are protected from claims by creditors of the structure. Note: the availability of asset protection is based on the structure itself. Care should always be taken to review loans/entitlements that may exist between the various parties, including personal guarantees that may have been given.		
Succession planning (estate planning)	■ The assets of the structure are not owned by any one unitholder and do not form part of an individual unitholder's estate on their death — although units would form part of that estate. ■ Ultimate control of the trust resides with the unitholders who, by resolution at a meeting, may remove and appoint trustees. Consideration should be given to which individual(s) or entity(ies) should hold the units.		

<table>
<tr><td rowspan="14">Key points guide</td><td>Income taxation</td><td colspan="3">

- Income accumulated by the structure will be taxed at the highest marginal income tax rate plus the Medicare levy.
- Flow-through taxation applies, so that income distributed by the structure will be taxed in the hands of the recipient at their income tax rate.
- The trustee has discretion to distribute income to holders of income units (a special class of units) to the exclusion of holders of units (the ordinary class of units).
- Where the trustee fails to exercise its discretionary power to distribute income in the manner outlined above, income of the structure will be distributed to unitholders in accordance with their proportionate unitholding.

</td></tr>
<tr><td rowspan="6">Capital gains tax concessions to structure</td><td colspan="2">50% discount</td><td>✓ Available</td></tr>
<tr><td rowspan="5">Small business concessions</td><td>50% active asset reduction</td><td>✓ Available (but the benefit is reduced by CGT event E4)[1]</td></tr>
<tr><td>15-year exemption</td><td>✓ Available (if there is a significant individual[2] throughout a total of 15 years)</td></tr>
<tr><td>Retirement exemption</td><td>✓ Available (if there is a significant individual[2] in year of disposal)</td></tr>
<tr><td>Roll-over</td><td>✓ Available</td></tr>
<tr><td colspan="2"></td></tr>
<tr><td rowspan="6">Capital gains tax concessions to fixed entitlement holders</td><td colspan="2">50% discount</td><td>✓ Available</td></tr>
<tr><td rowspan="5">Small business concessions</td><td>50% active asset reduction</td><td>✓ Available</td></tr>
<tr><td>15-year exemption</td><td>✓ Available (note the test period)</td></tr>
<tr><td>Retirement exemption</td><td>✓ Available</td></tr>
<tr><td>Roll-over</td><td>✓ Available</td></tr>
<tr><td colspan="2">Note small business CGT concessions are only available to a unitholder that is:
1. an individual who is a CGT concession stakeholder[3] in the income unit trust; or
2. an entity in which CGT concession stakeholders[3] of the income unit trust have an aggregate small business participation percentage[4] of 90%.</td></tr>
<tr><td></td><td colspan="3">Note: the availability of CGT concessions only relates to the availability to the structure. Consideration must be given to the requirements for accessing the concessions outlined in the ITAA97, and the requirement to distribute amounts of net capital gains in some circumstances to avoid the benefit of the concession being eroded by the gross-up rules in Subdiv 115-C ITAA97.</td></tr>
</table>

Key points guide		
	New investors	■ May apply for new units in the structure for which they will contribute funds, where the structure will use those funds for its activities. ■ May purchase units from existing unitholders.
	Other issues	■ Not appropriate if non-assessable income (save for any 50% CGT discount amount) will be derived.[1] ■ Not appropriate if franked dividends will be received — a family trust election would be required to allow beneficiaries to access more than $5,000 in franking credits and this may only be made in respect of one family. ■ Interest on borrowings to acquire units may not be deductible.[5] ■ The requirement to stream the non-assessable component of a capital gain with the assessable component of a capital gain as a result of the new Div 6E ITAA36 needs to be taken into consideration when determining to utilise this structure. ■ Not appropriate where revenue losses are involved (a fixed unit trust should be used instead).

1 Refer to "The CGT event E4 problem" in ¶7-105.

2 A "significant individual" is an individual who has a small business participation percentage[4] in the trust of at least 20% (see s 152-55 ITAA97).

3 A "CGT concession stakeholder" is a significant individual[2] of the trust or a spouse of the significant individual,[2] if the spouse has a small business participation percentage at that time greater than zero (see s 152-60 ITAA97).

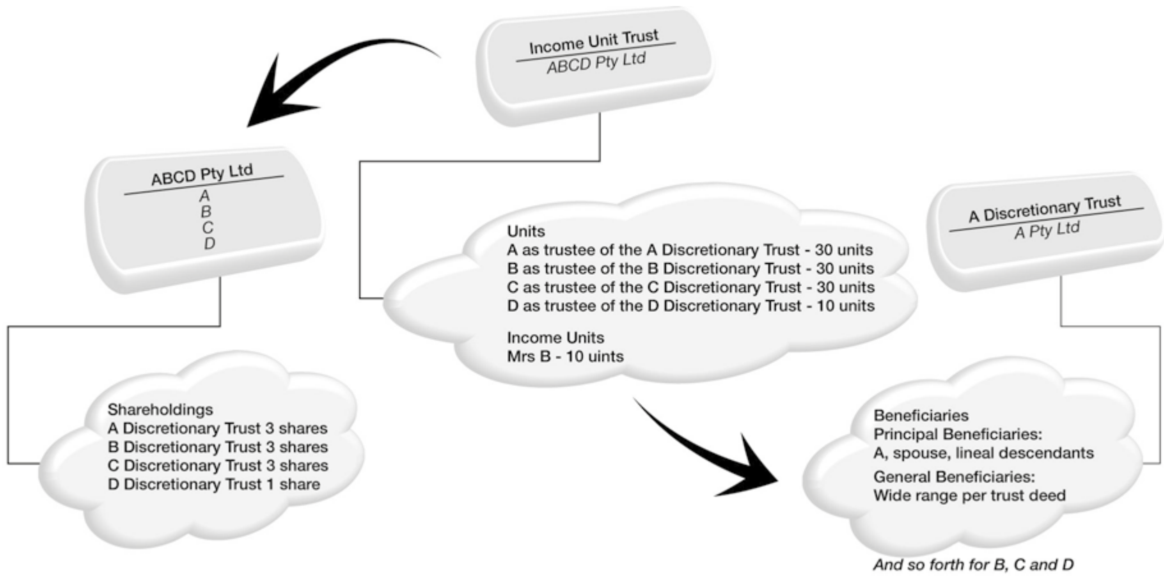
4 The meaning of "small business participation percentage" is outlined in ¶3-110 of this guide.

5 Refer to "Tax deductibility of interest incurred to acquire an interest in a trust" in ¶7-145 of this guide.

6 Refer to the *Tax Laws Amendment (2011 Measures No. 5) Act 2011* in ¶6-160 of this guide

Detailed guide — the income unit trust

The income unit trust is simply a version of the standard unit trust. As well as having standard units, the income unit trust allows the trustee to issue "income units" which carry a discretionary right to income.

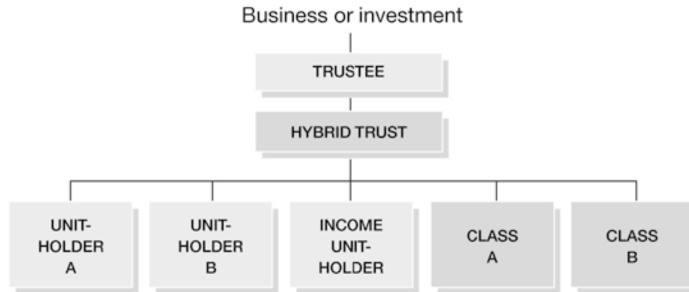


One possible application of the income unit trust is that income units could be issued to key employees (or their nominated entities) to give them the opportunity to receive income from the trust in a manner that does not affect control over the trust.

The only right attaching to income units are rights to receive income that the trustee determines in its discretion to distribute to income unitholders. The income unitholders have no fixed right to a proportion of the income of the income unit trust, have no right to capital other than the capital paid for the income units (if any) and have no voting rights.

If income units are issued to a key employee's discretionary trust, the trustee of the income unit trust would have the opportunity to distribute any income derived to the key employee's family members and related companies through the discretionary trust.

¶3-130 The hybrid trust (class income unit trust)

<table>
<tr><td rowspan="9">Key points guide</td><td>Diagram</td><td colspan="2">

Note: More comprehensive diagrams are provided in the detailed guide.</td></tr>
<tr><td>Suggested application</td><td colspan="2">■ To own and operate a business on behalf of multiple families where non-assessable income (including CGT concession amounts) will be derived.
■ To provide a key employee (or associate) the opportunity to receive income from the structure (at the trustee’s discretion) without providing any voting or capital rights through the issue of income units.</td></tr>
<tr><td rowspan="4">Parties</td><td>Who is the legal owner of the assets and makes decisions on a daily basis?</td><td>The trustee</td></tr>
<tr><td>Who owns a beneficial interest in the assets?</td><td>Unitholders</td></tr>
<tr><td>Who establishes the structure?</td><td>Unitholders by subscription</td></tr>
<tr><td>Who appoints the legal owner?</td><td>Unitholders by meeting</td></tr>
<tr><td rowspan="2">Asset protection</td><td colspan="2">■ The structure is protected from claims by creditors of those who hold interest in the structure (unitholders/beneficiaries) — although a unitholder’s interest in the structure may be seized by creditors.
■ Unitholders/beneficiaries are protected from claims by creditors of the structure.</td></tr>
<tr><td colspan="2">Note: the availability of asset protection is based on the structure itself. Care should always be taken to review loans/entitlements that may exist between the various parties, including personal guarantees that may have been given.</td></tr>
</table>

<table>
<tr><td rowspan="12">Key points guide</td><td>Income taxation</td><td colspan="3">Income accumulated by the structure will be taxed at the highest marginal income tax rate plus the Medicare levy.
Flow-through taxation applies, so that income distributed by the structure will be taxed in the hands of the recipient at their income tax rate.
There is flexibility to distribute income (including income with certain characteristics, eg franked dividends) to income unitholders, class beneficiaries or unitholders (subject to personal services income and Pt IVA issues).
Distribution within each “group” is proportionate to the interest held (ie 50% goes to each of Class A and Class B if there is equal entitlement) but the trustee has discretion to distribute income to income unitholders or class beneficiaries, to the exclusion of unitholders.
Class proportionate entitlements may be non-fixed if desired.
In default of the trustee’s exercise of discretion, income is distributed to unitholders in accordance with proportionate unitholding.</td></tr>
<tr><td rowspan="5">Capital gains tax concessions to the structure</td><td colspan="2">50% discount</td><td>✓ Available</td></tr>
<tr><td rowspan="4">Small business concessions</td><td>50% active asset reduction</td><td>✓ Available (but the benefit is reduced by CGT event E4 if the amount is not distributed to class beneficiaries)[1]</td></tr>
<tr><td>15-year exemption</td><td>✓ Available (if there is a significant individual[2] throughout a total of 15 years)</td></tr>
<tr><td>Retirement exemption</td><td>✓ Available (if there is a significant individual[2] in year of disposal)</td></tr>
<tr><td>Roll-over</td><td>✓ Available</td></tr>
<tr><td rowspan="6">Capital gains tax concessions to unitholders</td><td colspan="2">50% discount</td><td>✓ Available</td></tr>
<tr><td rowspan="5">Small business concessions</td><td>50% active asset reduction</td><td>✓ Available</td></tr>
<tr><td>15-year exemption</td><td>✓ Available (note the test period)</td></tr>
<tr><td>Retirement exemption</td><td>✓ Available</td></tr>
<tr><td>Roll-over</td><td></td></tr>
<tr><td colspan="2">Note: small business CGT concessions are only available to a unitholder that is:
1. an individual who is a CGT concession stakeholder[3] in the hybrid trust; or
2. an entity in which CGT concession stakeholders[3] of the hybrid trust have an aggregate small business participation percentage[4] of 90%.</td></tr>
</table>

Key points guide		Note: the availability of CGT concessions only relates to the availability to the structure. Consideration must be given to the requirements for accessing the concessions outlined in the ITAA97, and the requirement to distribute amounts of net capital gains in some circumstances to avoid the benefit of the concession being eroded by the gross-up rules in Subdiv 115-C ITAA97.
	Succession planning (estate planning)	■ The assets of the structure are not owned by any one unitholder or class beneficiary and do not form part of an individual unitholder or class beneficiary's estate on their death — although units would form part of that estate. ■ Ultimate control of the trust resides with the unitholders who, by resolution at a meeting, may remove and appoint trustees. Consideration should be given to which individual(s) or entity(ies) should hold the units.
	New investors	■ May apply for new units in the structure for which they will contribute funds that the structure will use for its activities. ■ May purchase units from existing unitholders.
	Other issues	■ Interest on borrowings to acquire units may not be deductible.[5] ■ The requirement to stream the non-assessable component of a capital gain with the assessable component of a capital gain as a result of the new Div 6E ITAA36 needs to be taken into consideration when determining to utilise this structure.[6] ■ Not appropriate where revenue losses are involved (use a fixed unit trust instead). ■ Not appropriate if franked dividends will be received — a family trust election would be required to allow beneficiaries to access greater than $5,000 in franking credits and this may only be made in respect of one family. ■ Non-assessable amounts may be distributed to class beneficiaries without triggering CGT event E4.[1] ■ The structure uses classes of beneficiaries where discretionary rights are to be provided. Some alternative structures use units with varying rights to income and capital but those units may still give rise to the CGT event E4 problem.[1]

1 Refer to "The CGT event E4 problem" in ¶7-105.

2 A "significant individual" is an individual who has a small business participation percentage[4] in the trust of at least 20% (see s 152-55 ITAA97).

3 A "CGT concession stakeholder" is a significant individual[2] of the trust or a spouse of the significant individual,[2] if the spouse has a small business participation percentage at that time greater than zero (see s 152-60 ITAA97).

4 The meaning of "small business participation percentage" is outlined in ¶3-110 of this guide.

5 Refer to "Tax deductibility of interest incurred to acquire an interest in a trust" in ¶7-145 of this guide.

6 Refer to the *Tax Laws Amendment (2011 Measures No. 5) Act 2011* in ¶6-160 of this guide.

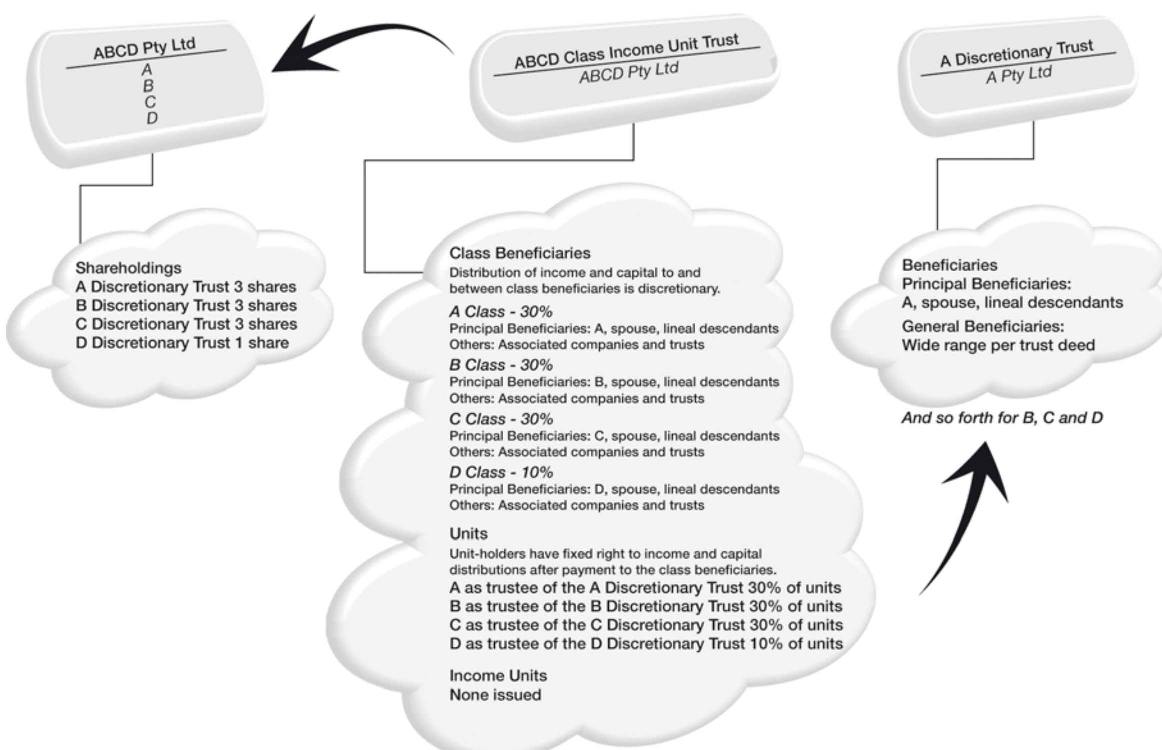
Detailed guide — the hybrid trust

The hybrid trust has:

- features of a discretionary trust; and
- features of a unit trust.

The hybrid trust is based on the standard discretionary trust (see ¶3-100 of this guide) with the added feature that it also offers a fixed (by unit) system of interest in the trust. An individual or an entity that is a beneficiary of the discretionary "part" of the trust (called a "class beneficiary") can also be a unitholder in the fixed "part" of the trust.

In the following example, A (who is an individual) and A's close relatives, associated companies and trusts become class beneficiaries, and the discretionary trust that A has set up becomes a unitholder in the hybrid trust.



Income and capital distributions

There are effectively three choices for the trustee to make in distributing the income of the hybrid trust and two choices in respect of the distribution of capital.

The first decision the trustee has to make is whether to distribute any of the income and capital of the hybrid trust to the class beneficiaries. If there is to be a distribution to the class beneficiaries, then the trustee must distribute the income and capital as between the classes, in accordance with each class' fixed proportionate entitlement that will be specified in the trust deed. Finally, the trustee must decide on the amount of a distribution of income or capital made to a particular class to be distributed to the various beneficiaries included in that class.

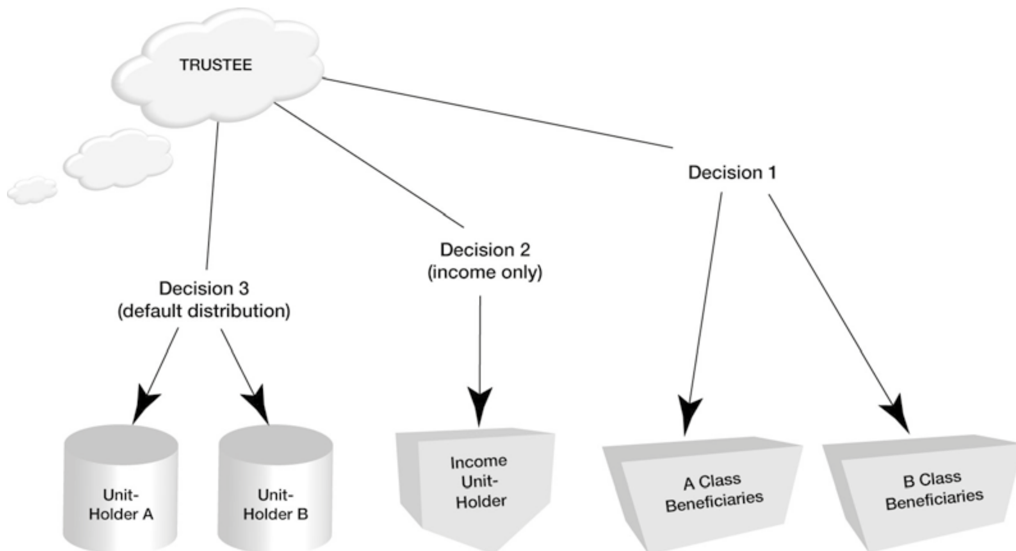
- For example, in the structure illustrated above, the trustee (ABCD Pty Ltd) decides to distribute an amount of $100,000 to the class beneficiaries. Thirty per cent of the amount is distributed to each of the A, B and C classes. D class receives 10%.
- The trustee would then need to determine who in each class will receive that distribution. In the example above, the trustee determines to distribute 100% of the A class amount to A, 50% of the B class amount to each of B and B's spouse, 100% of the C class amount to a company associated with C and 5% of the D class amount to D, with the balance going to D's children equally.

The second decision for the trustee is whether to distribute any income to the income unitholders (if any income units have been issued). If the trustee decides to distribute an amount to the income unitholders, that distribution need not be proportionate to the income unitholding. The trustee has absolute discretion to distribute amounts of income to one or more income unitholders to the exclusion of the others.

- In the structure illustrated above, no income units have been issued, and accordingly no distribution to income unitholders may be made.
- Income units are generally designed to benefit the families of key employees of a business conducted by the hybrid trust.
- The trustee could elect to issue income units to a trust associated with a key employee and, in the event the business has an extraordinarily profitable year, the trustee could (at its absolute discretion) decide to benefit the key employee's family by distributing an amount of income to the key employee's discretionary trust.

The third decision for the trustee is whether to distribute amounts of income and capital to the unitholders or to accumulate those amounts in the hybrid trust. Distributions to the unitholders must be proportionate to their unitholding.

Where the trustee fails to make a decision, the default provisions of the hybrid trust deed provide that the income of the hybrid trust is distributed to the unitholders proportionate to their unitholding.



Advantages of the structure

There are advantages in having class beneficiaries on the one hand and unitholders on the other hand.

The advantages of having class beneficiaries are:

- flexibility of income and capital distribution; and
- ability to distribute non-assessable income without giving rise to unit cost base adjustment capital gains pursuant to CGT event E4 — a problem that is faced by most unit trust deeds and their variants (see ¶7-105 of this guide), although note the potential impact of the new Div 6E (see ¶6-160 of this guide).

The advantage of having unitholders is that a unitised structure provides an easy mechanism by which:

- interests in the structure may be transferred to existing or new participants; or
- new interests may be allotted (eg where the new participant injects capital into the structure).

For a discussion of the resettlement issues, see ¶7-125 of this guide.

Units also provide a basis on which to determine the proportion of income and capital that may be distributed to the class beneficiaries. For example, in a standard version of the hybrid trust, the class of beneficiaries associated with a 50% unitholder would be entitled to 50% of all distributions to the classes of beneficiaries. The percentage entitlement of each class of beneficiaries is set out in the schedule to the trust deed and may, in special circumstances, differ from the percentage to which the unitholder is entitled.

Finally, the unitholding provides a mechanism whereby unitholders may vote on decisions that affect the hybrid trust — decisions such as who to appoint as trustee, whether to vary the trust, or how to determine obligations to contribute capital.

Income units enable the trustee to reward a key employee of the business with distributions of income to that employee's family or to a discretionary trust associated with the employee, in a manner that does not affect control over the hybrid trust.

The only rights attaching to income units are rights to receive income that the trustee, in its discretion, determines to distribute to income unitholders. The income unitholders have no fixed right to a proportion of the income of the hybrid trust, have no right to capital other than the capital paid for the income units (if any) and have no voting rights.

Asset protection issues

The structure can stand apart and separate from any other investments. Therefore, by virtue of their holding units in the hybrid trust, investments held by A, B, C and D in the example above, or the associated unitholding trusts (for example in real estate or shares) will be protected from the business risks (eg claims for professional negligence) to which the trustee of the hybrid trust may be exposed.

How the business of a hybrid trust is to be financed should be considered. If the business is to be financed by borrowings at the hybrid trust level, the financier may require security from the unitholding discretionary trusts. If this is the case, entities without substantial assets should hold the units. If substantial asset holding vehicles were to instead hold the units, the assets of those substantial asset holding vehicles may be exposed to the risks of the business conducted by the hybrid trust as a result of any guarantees provided.

Where natural persons hold the units, asset protection concerns need to be addressed. If a unitholder became bankrupt, the trustee in bankruptcy could "stand in the shoes" of the unitholder and take possession of units in the hybrid trust.

Holding units will not provide the trustee in bankruptcy with any power over the manner in which the trustee is to exercise its discretion in distributing income and capital, which may continue to be exercised in favour of the classes of beneficiaries. Accordingly, the trustee could distribute income and capital to the family, relatives or associated entities of the bankrupt natural person unitholder. Often the trustee can be replaced by a special resolution of unitholders so that, where a unitholder holding greater than 75% of the units in the trust becomes bankrupt, the trustee in bankruptcy could remove the trustee and appoint itself as trustee.

CGT implications

These issues are complicated and depend on specific circumstances. The general availability of the CGT concessions is outlined in the key points guide. Two issues require further clarification.

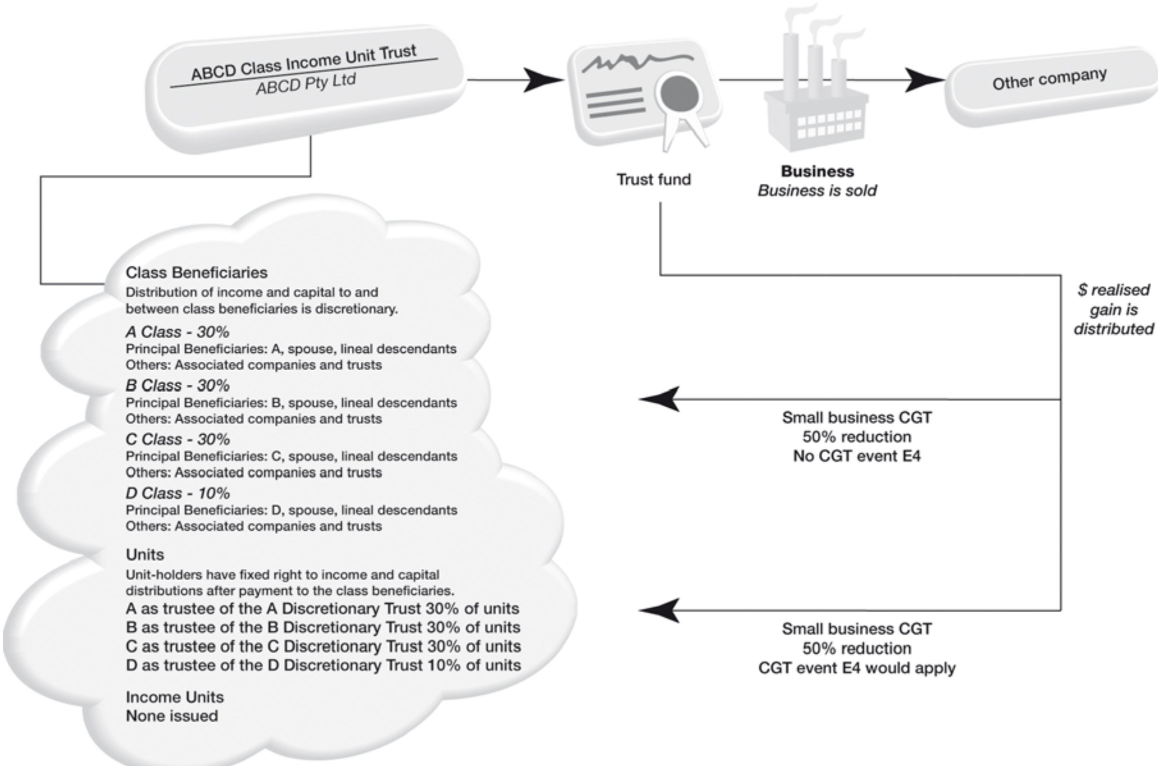
Disposal of units

See the discussion of the CGT implications of a unitholder disposing of their interest in a trust in the detailed guide concerning unit trusts at page 103.

To illustrate the differences between a hybrid trust and a unit trust, if, instead of a unit trust, the object trust in example 1 at page 109 was a hybrid trust then although unitholder A could still ensure that 90% of all distributions were made to an individual, it will be important to consider whether that individual is a CGT concession stakeholder in the object hybrid trust.

Because the hybrid trust is a non-fixed trust it is not sufficient to calculate the individual's small business participation percentage in the hybrid trust as simply a factor of the proportion of distributions received from unitholder, multiplied by the percentage unitholding held by unitholder A in the hybrid trust. Instead, whether the individual is a CGT concession stakeholder in the hybrid trust is determined by an analysis of all the distributions of income and capital actually made by the hybrid trust, including those made through the classes of beneficiaries. If there are distributions of both income and capital, then it is the smallest of the individual's entitlement to those distributions that is used when determining the individual's small business participation percentage.

The small business CGT 50% active asset reduction



As illustrated above, if the amount of the small business 50% active asset reduction is distributed to the unitholders, a further CGT liability may be incurred. The relevant CGT event is CGT event E4 pursuant to s 104-70 ITAA97 (see ¶7-105 of this guide).

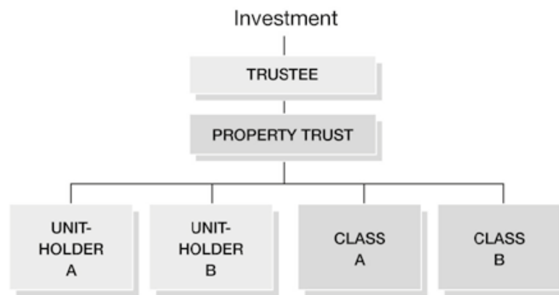
CGT event E4 does not apply to a distribution of the amount of the small business 50% active asset reduction if the amount is distributed to the class beneficiaries, as the distribution is not made in respect of an interest in the trust but rather, to discretionary objects of the trust. Accordingly, the same principles that apply in relation to the distribution of the amount by a standard discretionary trust apply where the amount is distributed through the class beneficiaries. No further CGT liability is incurred on the distribution of the amount. However, the introduction of the new Div 6E means that both the assessable and the non-assessable component of any capital gain must be streamed together (see ¶6-160 of this guide). If the non-assessable component of a capital gain is to be streamed to the class beneficiaries so that CGT event E4 is not triggered, the assessable component of the capital gain also needs to be streamed to the same beneficiaries.

For more explanation of the advantages of a discretionary trust, see "Advantages of a discretionary trust" at page 90.

For a discussion of the resettlement issues, see ¶7-125 of this guide.

¶3-135 The investment hybrid trust (class unit trust)

Key points guide

Diagram	 Note: More comprehensive diagrams are provided in the detailed guide.	
Suggested application	To hold multiple families' passive investments where interest expenses may be incurred on borrowings made to acquire units and where non-assessable income may be distributed.	
How does it work?	■ Non-assessable income only (not taxable income) may be distributed to the class beneficiaries at the trustee's discretion. ■ Distribution through the classes of beneficiaries follows a pattern similar to that of a discretionary trust. Accordingly, a distribution of non-assessable income to the class beneficiaries will not result in the CGT event E4 problem.[1] ■ Taxable income must be distributed to the unitholders.	
Parties	Who is the legal owner of the assets and makes decisions on a daily basis?	The trustee
	Who owns a beneficial interest in the assets?	Unitholders
	Who establishes the structure?	Unitholders by subscription
	Who appoints the legal owner?	Unitholders by meeting
Asset protection	■ The structure is protected from claims by creditors of those who hold interest in the structure (unitholders/beneficiaries) — although a unitholder's interest in the structure may be seized by creditors. ■ Unitholders/beneficiaries are protected from claims by creditors of structure. Note: the availability of asset protection is based on the structure itself. Care should always be taken to review loans/entitlements that may exist between the various parties including, personal guarantees that may have been given.	

<table>
<tr><td rowspan="14">Key points guide</td><td>Income taxation</td><td colspan="3">

- Income accumulated by the structure will be taxed at the highest marginal income tax rate plus the Medicare levy.
- Flow-through taxation applies, so that income distributed by the structure will be taxed in the hands of the recipient at their income tax rate.
- Assessable income (including income with certain characteristics, eg franked dividends) is distributed to unitholders (subject to personal services income and Pt IVA issues). Distributions to unitholders must be in accordance with the unitholders' proportionate entitlements to income.

</td></tr>
<tr><td rowspan="6">Capital gains tax concessions</td><td colspan="2">50% discount</td><td>✓ Available</td></tr>
<tr><td rowspan="5">Small business concessions</td><td>50% active asset reduction</td><td>✓ Available (but the benefit is reduced by CGT event E4 if the amount is not distributed to class beneficiaries)[1]</td></tr>
<tr><td>15-year exemption</td><td>✓ Available (if there is a significant individual[2] throughout a total of 15 years)</td></tr>
<tr><td>Retirement exemption</td><td>✓ Available (if there is a significant individual[2] in year of disposal)</td></tr>
<tr><td>Roll-over</td><td>✓ Available</td></tr>
<tr><td colspan="3"></td></tr>
<tr><td rowspan="6">Capital gains tax concessions to unitholders</td><td colspan="2">50% discount</td><td>✓ Available</td></tr>
<tr><td rowspan="5">Small business concessions</td><td>50% active asset reduction</td><td>✓ Available</td></tr>
<tr><td>15-year exemption</td><td>✓ Available (note the test period)</td></tr>
<tr><td>Retirement exemption</td><td>✓ Available</td></tr>
<tr><td>Roll-over</td><td></td></tr>
<tr><td colspan="2">Note: small business CGT concessions are only available to a unitholder that is:
1. an individual who is a CGT concession stakeholder[3] in the investment hybrid trust; or
2. an entity in which CGT concession stakeholders[3] of the investment hybrid trust have an aggregate small business participation percentage[2] of 90%.</td></tr>
<tr><td></td><td colspan="3">Note: the availability of CGT concessions only relates to the availability to the structure. Consideration must be given to the requirements for accessing the concessions outlined in the ITAA97, and the requirement to distribute amounts of net capital gains in some circumstances to avoid the benefit of the concession being eroded by the gross-up rules in Subdiv 115-C ITAA97.</td></tr>
</table>

Key points guide		
	Succession planning (estate planning)	■ The assets of the structure are not owned by any one unitholder or class beneficiary and do not form part of an individual unitholder or class beneficiary's estate on their death — although units would form part of that estate. ■ Ultimate control of the trust resides with the unitholders, who by resolution at a meeting, may remove and appoint trustees. Consideration should be given to which individual(s) or entity(ies) should hold the units.
	New investors	■ May apply for new units in the structure for which they will contribute funds that the structure will use for its activities. ■ May purchase units from existing unitholders.
	Other issues	■ Interest on borrowings to acquire units may be deductible however in light of the position taken by the Commissioner in TD 2009/17 consideration will need to be given to whether only a proportion of the interest expense incurred is deductible. Issues relating to interest deductibility are addressed in ¶7-145 of this guide. ■ Not appropriate where revenue losses are involved (use fixed unit trust instead). ■ Not appropriate if franked dividends will be received — a family trust election would be required to allow beneficiaries to access greater than $5,000 in franking credits and this may only be made in respect of one family. ■ Non-assessable amounts may be distributed to class beneficiaries without triggering CGT event E4.[1] ■ The structure uses classes of beneficiaries where discretionary rights are to be provided. Some alternative structures use units with varying rights to income and capital but those units may still give rise to the CGT event E4 problem.[1] ■ The requirement to stream the non-assessable component of a capital gain with the assessable component of a capital gain as a result of the new Div 6E needs to be taken into consideration when determining to utilise this structure.[5]

1 Refer to "The CGT event E4 problem" in ¶7-105.

2 A "significant individual" is an individual who has a small business participation percentage[4] in the trust of at least 20% (see s 152-55 ITAA97).

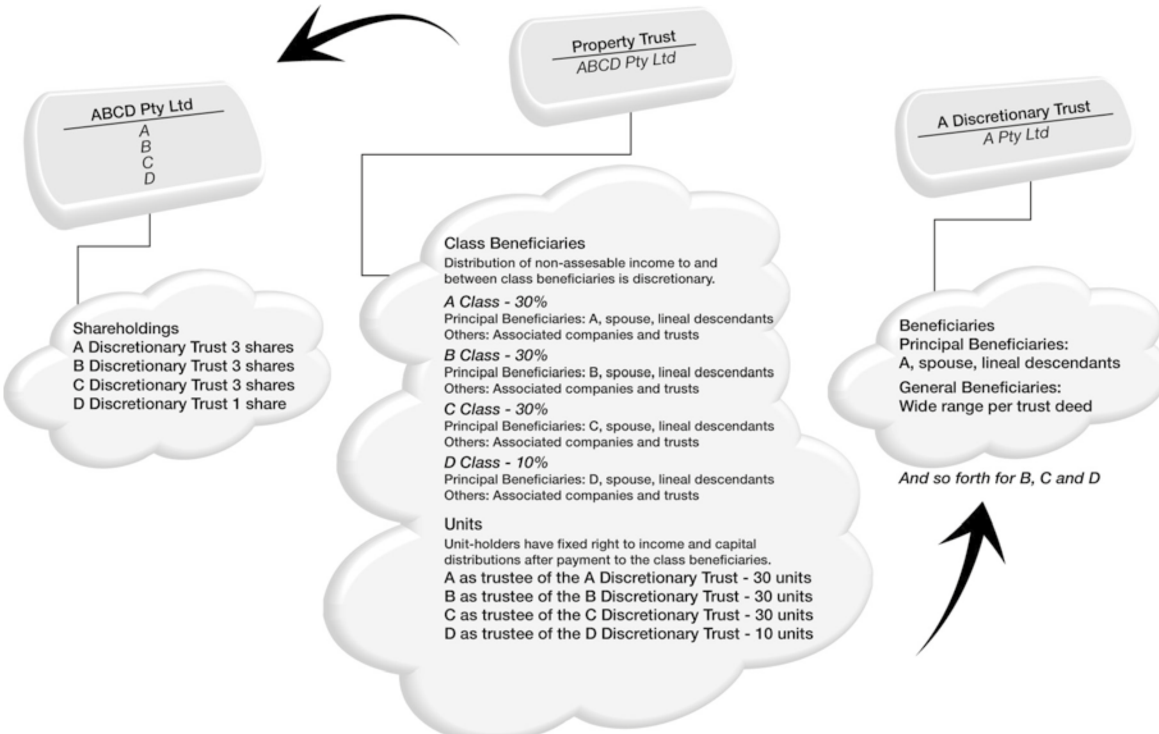
3 A "CGT concession stakeholder" is a significant individual[2] of the trust or a spouse of the significant individual,[2] if the spouse has a small business participation percentage at that time greater than zero (see s 152-60 ITAA97).

4 The meaning of "small business participation percentage" is outlined in ¶3-110 of this guide.

5 Refer to the *Tax Laws Amendment (2011 Measures No. 5) Act 2011* in ¶6-160 of this guide.

Detailed guide — the investment hybrid trust

The investment hybrid trust is very similar in structure and operation to the hybrid trust (see ¶3-130 of this guide).



There are two significant differences that should be outlined.

First, all taxable income derived by the investment hybrid trust must be distributed to the unitholders in proportion to the number of units they hold. The trustee only has discretion to distribute non-assessable amounts of income and capital (such as trust income after the application of income tax deductions for depreciation) to the class beneficiaries. It is important to note the potential impact of the new Div 6E (see ¶6-160 of this guide) which requires both the assessable and non-assessable component of a capital gain to be streamed together.

The investment hybrid trust is specifically drafted in this manner for the purpose of property investment. Interest on borrowings used to acquire units in the structure may be tax deductible but note the implications of TD 2009/17. In particular, the Commissioner makes the following statement in TD 2009/17 at para 2:

> *The taxpayer's interest expense can only be deducted to the extent to which the taxpayer has used borrowed moneys to gain or produce assessable income of the taxpayer. The interest will not be deductible to the extent that the taxpayer has used the borrowed moneys for the purpose of benefiting persons other than the taxpayer.*

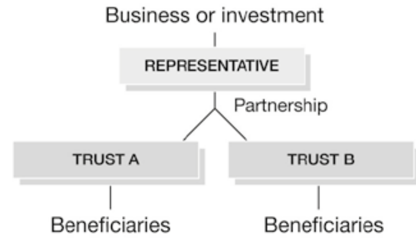
The Commissioner may argue that the ability to distribute non-assessable income to class beneficiaries is indicative of a purpose of those investing in the trust to benefit persons other than the taxpayer investor. Such arguments are at present untested by the courts. However, in light of the approach taken by the Commissioner in TD 2009/17, only a proportion of the interest expense incurred in respect of borrowings used to acquire units in this structure may be deductible. If this is the case an apportionment calculation to determine the extent of the deductibility of the interest expense will need to be undertaken.

Taxpayers concerned about the Commissioner's statements in TD 2009/17 could adopt more restrictive forms of investment hybrid trust deeds. Issues relating to interest deductibility are addressed in more detail in ¶7-145 of this guide.

Second, and consistent with the comments above, there are no income units incorporated into the trust deed and, therefore, there is no immediate ability to reward key employees on a non-capital, non-voting basis.

¶3-140 The partnership of discretionary trusts

Key points guide

Diagram	 Note: More comprehensive diagrams are provided in the detailed guide.	
Suggested application	■ To own and operate a business on behalf of multiple families. ■ To hold multiple families' passive investments (inc shares or property). Note: applies where access to the small business CGT concessions or the ability of each discretionary trust partner to make its own family trust election is important.	
Parties	Who is the legal owner of the assets and makes decisions on a daily basis?	Representative
	Who owns a beneficial interest in the assets?	Beneficiaries of the discretionary trust partners (but they do not have a fixed interest in the assets)
	Who establishes the structure?	Trustees of the discretionary trust partners
	Who appoints the legal owner?	Trustees of the discretionary trust partners
Asset protection	■ The structure is *not* protected from claims by creditors of discretionary trust partners. ■ Discretionary trust partners are *not* protected from claims by creditors of structure. In fact, discretionary trust partners have joint and several liability for any liabilities of the structure. ■ Discretionary trust partners are protected from claims by creditors of beneficiaries. ■ Beneficiaries are protected from claims by creditors of discretionary trust partners. Note: the availability of asset protection is based on the structure itself. Care should always be taken to review loans/entitlements that may exist between the various parties, including personal guarantees that may have been given.	

Key points guide

Income taxation	■ Income accumulated by the structure will be taxed in the hands of the discretionary trust partners at the highest marginal income tax rate plus the Medicare levy. ■ Flow-through taxation applies, so that income distributed by the discretionary trust partners will be taxed in the hands of the recipients at their income tax rate. ■ There is flexibility to distribute income (including income with certain characteristics, eg franked dividends) to any one or more beneficiaries of the discretionary trust partners (subject to personal services income and Pt IVA issues).		
Capital gains tax concessions available to each partner		Relevant CGT asset	The interest in the partnership (s 108-5 ITAA97)
		50% discount	✓ Available
	Small business concessions	50% active asset reduction	✓ Available
	Small business concessions	15-year exemption	✓ Available (if there is a significant individual[1] throughout a total of 15 years)
	Small business concessions	Retirement exemption	✓ Available (if there is a significant individual[1] in year of disposal)
	Small business concessions	Roll-over	✓ Available
	Note: the availability of CGT concessions only relates to the availability to the structure. Consideration must be given to the requirements for accessing the concessions outlined in the ITAA97, and the requirement to distribute amounts of net capital gains in some circumstances to avoid the benefit of the concession being eroded by the gross-up rules in Subdiv 115-C ITAA97.		
Succession planning (estate planning)	■ The assets of the structure are not owned by any one beneficiary and do not form part of a beneficiary's estate on their death. ■ No discretionary trust partner has any specific interest in the partnership. ■ Ultimate control of the structure resides with the discretionary trust partners, who may at a meeting remove and appoint trustees.		
New investors	Varying the proportionate interests in the partnership, or adding new partners, may result in a CGT liability for the partners.		
Other issues	■ A significant benefit is that each discretionary trust partner may make their own decisions concerning the ability to access the small business CGT concessions, determining the existence of a controlling individual and making family trust elections and interposed entity elections. The ability of each discretionary trust partner to make their own decisions in respect of making family trust elections and interposed entity elections is important to enable the discretionary trust partner to carry forward losses and to distribute franked dividends. ■ Alternative structures (such as hybrid trusts) jointly assess the relevant tests and accordingly may not satisfy small business CGT concession requirements such as the controlling individual test.		

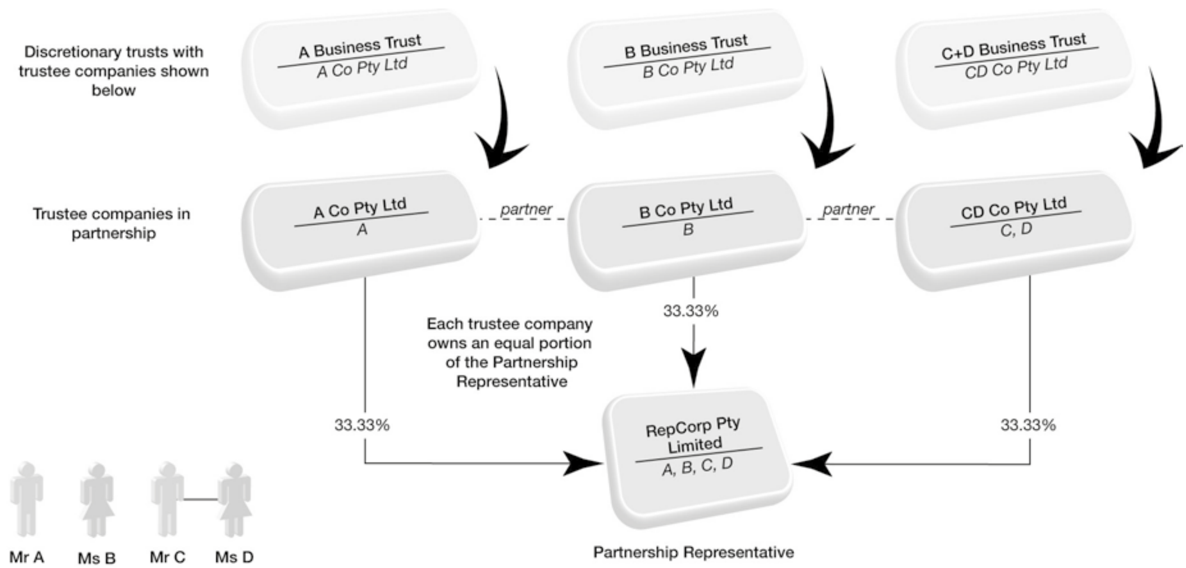
1 A "significant individual" is an individual who has a small business participation percentage[2] in the trust of at least 20% (see s 152-55 ITAA97).

2 The meaning of "small business participation percentage" is outlined in ¶3-110 of this guide.

Detailed guide — the partnership of discretionary trusts

Establishment of the partnership

A, B, C and D are all natural persons. Each has set up a company and a discretionary trust. Each company acts as trustee for one of the discretionary trusts (A has set up A Co Pty Ltd, which acts as trustee for the A Business Trust; B Co Pty Ltd acts as trustee for the B Business Trust; and CD Co Pty Ltd acts as trustee for the C+D Business Trust). As a group, they set up another company (RepCorp Pty Ltd), which acts as the representative for the partnership.



Each trustee company enters into a partnership agreement to regulate the rights and liabilities between them. So each company, as trustee of a discretionary trust, becomes a partner (ie a discretionary trust partner).

The partnership agreement between the three discretionary trust partners includes all the provisions commonly included in a unit trust deed (including a limitation of liability of the partners). Accordingly, the partnership effectively operates in the same manner as a unit trust. In fact, under the partnership agreement, the responsibility and power of the partnership representative, RepCorp Pty Ltd, is similar to those of the trustee of a unit trust.

The partnership agreement covers:

- the rights of a discretionary trust partner to transfer its partnership interests;
- the powers of RepCorp Pty Ltd in respect of the partnership;
- the limitation on the ability of a discretionary trust partner to charge its partnership interests;
- the manner in which meetings of the partnership are to be held and votes cast;
- the admission of new partners;

- the raising of capital; and
- the winding-up of the partnership.

Operation of the structure

This structure has been designed to combine the benefits of a partnership with the administrative convenience of having a corporate representative for the partnership. When the partners are trusts, the availability of the small business CGT concessions is maximised. An alternative structure through which a number of entities may conduct a business is a hybrid trust (see ¶3-130 of this guide).

- For the purposes of applying the various CGT concessions, a hybrid trust is a single entity.
- Under a partnership of trusts, each trust in the partnership individually applies the concessions to determine the tax liability arising from a capital gain made from the disposal of an interest in the partnership. Each interest of the partners in the partnership is a separate asset for CGT purposes.

Each discretionary trust partner has control over the tax treatment of its share of the partnership's profits and capital.

The representative appointed in respect of the partnership business is a company in which the discretionary trust partners hold a proportion of the shares on issue. The proportions are equal to the partners' proportionate interest in the partnership, with each partner having the right to nominate one director. The discretionary trust partners may remove and replace the representative by special resolution. The representative is empowered to conduct the partnership business and to do so in its own name.

The extent of the interest of each discretionary trust partner in the partnership is described by holding "units" in the partnership. The relationship, established under the partnership agreement, is not that of a unit trust; the holding of "units" is simply a way of expressing the share in the partnership that each partner holds.

Representative

The representative is the public face of the partnership business to its customers and suppliers (eg tax invoices may be issued in the name of the representative). It is not necessary for a partnership business to have a representative but if it does it is recommended that the representative is a company (see "GST and ABN registration" below).

The role of the representative is to operate the partnership business on a day-to-day basis, but ultimate control of the business remains with the discretionary trust partners.

The representative can act in various capacities which include as bare trustee, as agent and in its own capacity.

Bare trustee

The representative may own assets, such as the business name or premises, as bare trustee for the partnership. A bare trust arises where one person (the bare trustee) holds the legal title to property on trust as nominee for another (the beneficial owner). The bare trustee has no discretion in relation to the property and must transfer that property to the beneficial owner at their direction.

Bare trusts are now recognised by the Commissioner of Taxation as a legal relationship in which the beneficiary has an absolute, indefeasible entitlement to the capital and income of the trust (unlike a discretionary trust where a beneficiary does not have such entitlement to the trust property). A bare trustee therefore is exempt from lodging a tax return in respect of the property of the bare trust. Instead the beneficiary of the trust is taxed in respect of the income and capital gains and must file a tax return.

Agent

A representative can act as agent for the partnership in relation to the carrying on of the business and issuing tax invoices.

The agency relationship involves the authorisation of an agent to act on behalf of another, the principal, to create a legal relationship with a third party, regardless of whether the principal is disclosed to the third party. In other words, the principal is legally responsible for the acts of the agent. In the situation of a partnership of trusts, the partner trusts would be liable for the acts of the representative and any claims against it.

The agent is entitled to full reimbursement by the partnership of all costs incurred by the agent.

Unlike a bare trust, there is no requirement that the property must be vested in the agent. An agent usually only has possession of property on behalf of the principal, not title to that property.

In its own capacity

The representative of the partnership business may choose to employ staff in its own right as employer. In some professions, this is a requirement under legislation.

As outlined above, the representative can act in various capacities and the capacity in which it is acting determines the tax treatment of the income and capital gains of the partnership business. For example, capital gains made on the sale of a business asset held by the representative are assessable in the hands of the partner trusts.

Liability issues

The only issue of uncertainty in relation to the provisions of the partnership agreement is the limitation of the discretionary trust partners' liability. To isolate liability for claims in respect of the partnership business to RepCorp Pty Ltd, the partnership agreement provides that in consideration for RepCorp Pty Ltd:

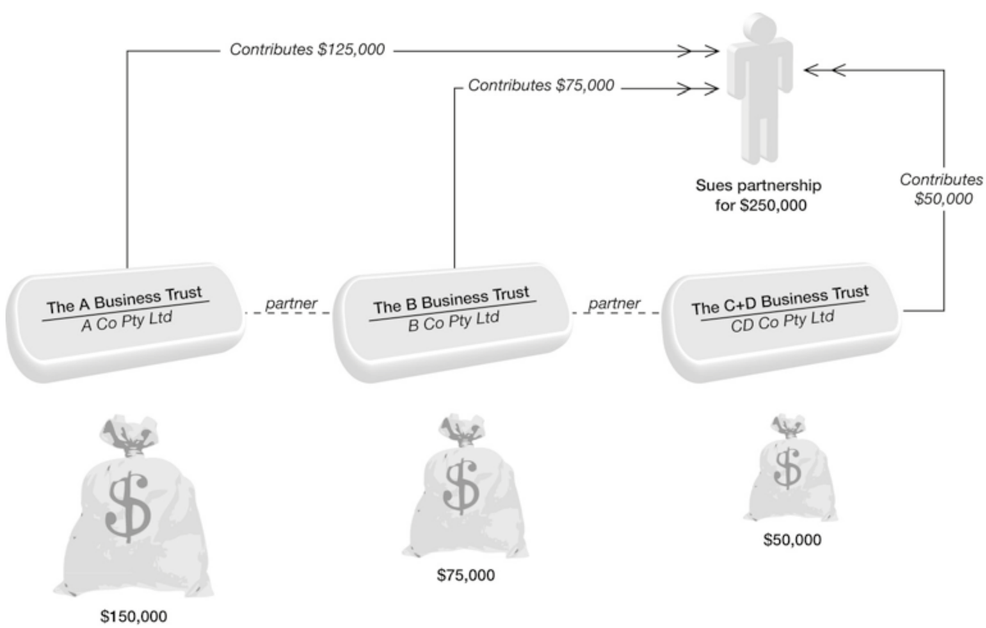
- accepting appointment as partnership representative; and
- receiving a fee for the provision of services to the partnership;

RepCorp Pty Ltd agrees to accept liability for all claims arising from the operation of the partnership business.

Despite the clause under which RepCorp Pty Ltd accepts liability for all claims relating to the operation of the business, each of the discretionary trust partners is jointly and severally liable for the total amount payable in respect of any claim made. Each partner would have a right of indemnity against the other discretionary trust partners to the extent of their percentage interest in the partnership. However, if one of the discretionary trust partners had insufficient assets to satisfy its share of the claim, the other discretionary trust partners would be obliged to contribute more than their proportionate share.

For example, suppose that the partnership was successfully sued for $250,000 and the claimant (the plaintiff) sought recovery only from the C+D Business Trust. If each of the discretionary trust partners had assets of $500,000, the C+D Business Trust would pay the whole amount to the plaintiff and then would seek contribution from the A Business Trust and the B Business Trust. As each discretionary trust partner holds an equal third interest in the partnership, contributions would be equal. Accordingly, the C+D Business Trust would seek $83,333 from each of the other business trusts.

If, however, one or more of the discretionary trust partners was unable to contribute an equal amount, the discretionary trust partner that could contribute would be liable for any shortfall. As the following diagram shows, if neither the B Business Trust nor the C+D Business Trust could pay their $83,333 contribution, and the A Business Trust could, the A Business Trust would be obligated to pay the balance of the money owing.



It is also important, for the protection of the partnership assets, that each discretionary trust partner has a corporate trustee. This ensures that each partner is not exposed to any other business or personal liabilities which may expose the assets of the partnership.

> Therefore, if a partnership of trusts is established to conduct a business, it is recommended that none of the discretionary trust partners hold any assets other than their respective interest in the partnership.

GST and ABN registration

Section 8 of the *A New Tax System (Australian Business Number) Act 1999* sets out who is entitled to an Australian Business Number (ABN). Subsection (1) provides that to be entitled to an ABN you must be carrying on an enterprise in Australia or you make supplies that connected with Australia in the course or furtherance of carrying on an enterprise. Subsection (2) provides that a company is entitled to have an ABN. Therefore a company acting as agent for a partnership is entitled to have an ABN. The position is less clear if the agent is not a company.

Not sure which structure to use? Use the chart at ¶2-110.

If the agent is not a company, MT 2006/1, in considering the entitlement to an ABN under s 8(1), states at para 112 that "The agent is not entitled to an ABN in its capacity as an agent. The agent is entitled to an ABN if it carries on an enterprise in its own right." Accordingly, only an agent for a partnership that is a company or carries on an enterprise in its own right will be permitted to have an ABN. It is recommended that a company be appointed as the agent.

Subject to the comments above both the partnership and the agent should each obtain an ABN. However, unless the agent intends to make taxable supplies in its own right, rather than merely as agent, only the partnership needs to register for GST purposes.

The partnership agreement provides that the representative is acting as an agent for the partnership. Accordingly, although the supplies to third parties may be made by the representative, the representative will only be making those supplies as agent for the partnership. At all times, the partnership will be the entity making the actual supply to a third party. As explained in GSTR 2000/37 at para 45:

> *When an agent is authorised to undertake a transaction on behalf of the principal, thereby binding the principal to the legal effects of the transaction, then the transaction is made by the principal through the agent.*

Therefore, a taxable supply made in the course of the conduct of a business is made by the partnership. Under the general principles of the GST legislation, the partnership would be required to issue a tax invoice to the recipient of the supply if the recipient requested it or if the terms of the agreement with the recipient required the giving of a tax invoice. However, Subdiv 153-A of the *A New Tax System (Goods and Services Tax) Act 1999* (GSTA99) provides that the supplier (ie the partnership) of the taxable supply satisfies its obligations to issue a tax invoice for a taxable supply made through an agent if the tax invoice is issued by the agent. This is acknowledged by the Commissioner in GSTR 2000/37 at para 61 as follows:

> *Paragraph 29-70(1)(a) requires that the principal (as the supplier) must issue a tax invoice for a taxable supply. However, if a principal makes a taxable supply through an agent, s 153-15 allows either a principal or an agent, but not both, to issue the tax invoice.*

The position concerning tax invoices is further clarified at para 65 of the ruling where the Commissioner states:

> *Regulation 29-70.01 of the GST regulations states, inter alia, that the tax invoice must contain the name of the supplier. However, where an agent issues the tax invoice, that document is a tax invoice and it meets the requirements of subsection 29-70(1) if it sets out:*

- *the principal's name and ABN without the agent's name and ABN as the supplier and issuer of the tax invoice; or*
- *the agent's name and ABN as the supplier and issuer, instead of the principal's name and ABN as the supplier.*

Accordingly, recipients of supplies made by the partnership may deal directly with the agent in relation to those supplies. Proceeding in this manner will allow the agent to remain the entity identified by the public. It may be involved in all transactions on behalf of the partnership and issue tax invoices with its name and ABN.

Although tax invoices may be issued by the agent, the partnership will be required to lodge a business activity statement (BAS) after the end of each tax period in relation to those supplies made by it.

Where the partnership reimburses expenses incurred by the agent, it may be entitled to claim the input tax credits in relation to the acquisitions made by the agent that it is reimbursing.

Division 111 GSTA99 provides that the reimbursement of the agent is deemed to be consideration for an acquisition made from the agent. The division further provides that although the supply from the agent is not a taxable supply, this does not stop the acquisition of the supply being a "creditable acquisition". Where the acquisition is a "creditable acquisition", the partnership would be entitled to the input tax credits in relation to the acquisition.

The partnership would only be entitled to claim input tax credits in relation to the reimbursement if the agent had not already done so and either it or the agent held a tax invoice in relation to the original acquisition of the supply being reimbursed. There are additional conditions that must be satisfied for the partnership to claim the input tax credits. For example, there is a requirement that the incurring of the expense by the agent is related to that party's activities as the partnership's agent, and that the reimbursement does not constitute a fringe benefit.

There is an alternative to the GST treatment of the agency relationship pursuant to Subdiv 153-A GSTA99 described above.

Subdivision 153-B GSTA99 enables an agent to act as a principal for the purposes of accounting for GST only, so that in respect of supplies made by the representative to third parties, the supplies are treated each as an independent supply by the representative to the third party and a corresponding separate supply between the partnership and the representative with the representative and the partnership treated as acting between a principal and another principal. In these circumstances the supply between the partnership and the representative is also a taxable supply (GSTR 2000/37 at paras 24 and 78). The purpose of this general agency is to simplify the GST treatment of rendering accounts in accordance with GSTR 2000/37. In order for this principal to principal arrangement to apply, the manager and partnership must agree in writing to apply Subdiv 153-B.

The partnership of trusts agreement may also provide for payment of remuneration to the agent for its services. The provision of those services would be a taxable supply made to the partnership in the ordinary manner.

New investors

The most significant disadvantage with this structure is that the introduction of a new discretionary trust partner would necessarily involve a disposal of an interest in the partnership by each existing discretionary trust partner. For example, if the three equal discretionary trust partners allowed two new equal discretionary trust partners into the partnership, each existing partner would be disposing of a 13.33% interest in the partnership. This would, if the market value of the business assets exceeded their cost base, trigger a capital gain. However, the amount of the capital gain might be reduced by the 50% CGT discount, the 50% active assets reduction and the retirement exemption.

If there are to be new investors in the future and those new investors are to be offered new interests in the structure (ie they will be injecting capital into the structure rather than merely purchasing the existing investors' interests) a hybrid trust may be the preferred structure to be adopted. Under a hybrid trust structure new investors can subscribe for new units in the hybrid trust which will be allotted to the investor in exchange for the subscription sum. A simple allotment of new units in a hybrid trust will not trigger a CGT event if made for full market value.

This can be contrasted with a partnership of trusts. Where new investors are injecting capital into a partnership of trusts, the existing discretionary trust partners effectively dispose of their existing interests in the partnership (an interest in a partnership is a CGT asset), thereby creating a new partnership of trusts. The disposal of the existing interest in the partnership by the existing partners gives rise to a CGT event — that is, the disposal of their interest in the partnership. Clearly, it is undesirable to trigger a CGT liability merely because of the admission of a new partner.

However, if there are to be new investors and the new investors are to acquire existing interests in the business, or if there are to be no new investors at all, then a partnership of trusts may be the most appropriate structure to adopt. The partnership of trusts structure is to be preferred over the hybrid trust structure because, under the partnership of trusts structure, one or more of the small business CGT concessions may be available in circumstances where those same small business concessions will not be available under a hybrid trust structure.

Use of revenue losses

The income of each of the discretionary trust partners is received before tax. The discretionary trust partners will then be entitled to offset any current year or carried forward losses against the partnership income. After the application of losses against the share of the partnership income of a discretionary trust partner, the remainder would be the net or taxable income of that discretionary trust partner.

Family trust election

A partnership of discretionary trusts is also a preferred structure to use in relation to the making of family trust elections. As each trust assesses its taxation obligations individually and is a separate entity, each trust may determine whether or not to make a family trust election.

The trust may wish to make a family trust election (or interposed entity election) for several reasons, including:

- to enable carried forward revenue losses to be offset against the income derived from the partnership business;
- to claim certain debt deductions;
- to enable beneficiaries to claim greater than $5,000 in franking credits (see ¶7-110 of this guide);
- so that it can distribute income to other entities in a group where the family trust election has been made.

Under the trust loss provisions of Sch 2F ITAA36 there are fewer tests for a family trust to satisfy in order to claim tax losses and certain debt deductions. To satisfy the meaning of "family trust" in this Schedule, a trust must be able to make a family trust election.

The decision by one of the discretionary trust partners to make the family trust election will not impact on the other discretionary trust partners who may continue to determine whether they will make a family trust election within their own family group, or proceed without making any such election.

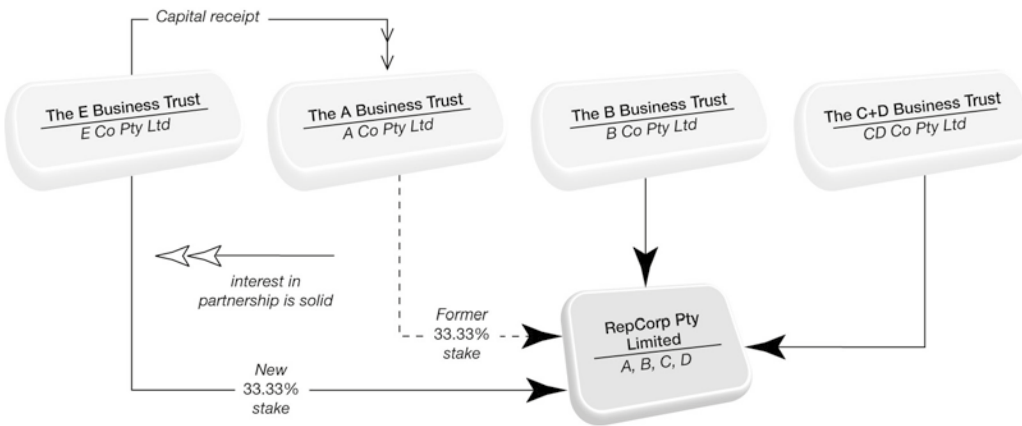
In respect of alternative structures such as a unit trust or hybrid trust, in which multiple family groups invest, a family trust election or interposed entity election cannot be made unless the trust is controlled (eg more than 50% is held by one family group). Where the family trust election is made, distributions should not be made other than to members of the controlling family group. Otherwise, there will be a liability for family trust distribution tax. In practical terms, the family trust election is not available under unit trusts or hybrid trusts in which multiple family groups hold an interest, without severe taxation consequences. Such an election would be required to be limited to one family group with the result that distributions to other families (even if in respect of their unit holding) would result in a liability for family trust distribution tax at 45% plus the Medicare levy.

Capital gains tax implications

Disposal of an interest or part of an interest in the partnership

An interest in a partnership is specifically identified as a CGT asset in s 108-5(2)(d) ITAA97.

In the following example, each 33.33% interest of the three business trusts in the partnership assets is a separate asset for CGT purposes. Subject to the partnership agreement, a partner can sell its interest in the partnership. For example, if the A Business Trust were to sell its interest to E Co Pty Ltd, the A Business Trust would derive a capital gain. The 50% CGT discount and the small business CGT concessions might apply.



50% CGT discount

The 50% CGT discount provided in Div 115 ITAA97 may be available where the relevant CGT asset has been held for 12 months.

Small business CGT concessions

The small business 50% active asset reduction, the small business retirement exemption, the small business roll-over and the small business 15-year exemption are small business CGT concessions contained in Div 152 ITAA97. The availability of the small business CGT concessions is subject to the satisfaction of the basic conditions for relief, specified in Subdiv 152-A ITAA97.

Basic conditions for relief

The basic conditions for relief include the requirement that the maximum net asset value test (s 152-15 ITAA97) be satisfied. Prior to the introduction of the *Tax Laws Amendment (Small Business) Act 2007*, the test provided that the small business CGT concessions would only be available where the net assets of the entity which disposed of an asset, and any connected entities of that entity and of any partnership of which that entity is a member, did not exceed $5m. This threshold was increased to $6m effective from 1 July 2007 by the *Tax Laws Amendment (Small Business) Act 2007* (the $6m threshold). The figure of $6m is not to be indexed for inflation.

Formerly, s 152-15(b) ITAA97 provided a separate partnership asset test, which limited the small business concessions to partners who satisfied the maximum net asset value test and where the total partnership assets were less than that threshold.

The combination of the repeal of the separate total partnership assets test, the partnership not being a small business CGT affiliate of the partner, and the presumption that partners are not connected entities means that very large partnerships can form. Each partner can qualify for the small business concessions provided the partner's partnership interest and other relevant assets do not exceed the maximum net asset value test.

It is important to note that the connected entity test may still apply to group the partnership with a partner. A partner with a drawing entitlement that exceeds 40% may be aggregated with the partnership when determining whether the partner satisfies the maximum net asset value test.

Connected entities

By press release dated 16 October 2003, the Assistant Treasurer announced changes to improve access to the small business CGT concessions. The changes were later introduced by the *Tax Laws Amendment (2004 Measures No. 1) Act 2004*, which received royal assent on 29 June 2004.

The amendments are retrospective and operate from the introduction of the small business CGT concessions on 21 September 1999. The amendments provide that connected entities of a discretionary trust will only include beneficiaries who received a distribution of income or capital of 40% or more in any one of the four income years before the income year for which access to the small business CGT concessions is sought. Distributions to deductible gift recipients and tax exempt entities (eg a charity) are ignored for the purpose of determining connected entities. The amendments propose that for an income year in which the discretionary trust has a tax loss or fails to make a distribution of income or capital, the trustee of the discretionary trust may nominate up to four beneficiaries as being controllers of the discretionary trust.

Although the amended provisions are intended to operate as from 21 September 1999, taxpayers were entitled to choose to apply the previous connected entity test provisions (with the exclusion of deductible gift recipients and tax exempt entities) until the end of the 2003/04 income year.

Assets excluded for the purposes of determining whether the $6m threshold has been breached include:

- shares and units held in other connected entities;
- personal use assets;
- principal residence and other properties used for personal residential purposes; and
- life insurance and superannuation entitlements.

The *Tax Laws Amendment (Small Business) Act 2007* also introduced an alternative test to the $6m threshold which is often referred to as the "$2 million turnover test". The $2 million turnover test is able to be satisfied by a taxpayer in three ways, being:

- where the taxpayer has a maximum turnover threshold in the previous year of not more than $2m; or
- where the taxpayer has a maximum turnover threshold in the estimated current year (worked out as at the first day of the income year) which is likely to be not more than $2m; or
- where the taxpayer has a maximum turnover threshold in the current income year (worked out as at the end of the current income year) of not more than $2m.

The $2 million turnover test applies to the total business ordinary income of the entity and therefore requires the taxpayer to conduct a business in order for the $2 million turnover test to apply.

Ordinary income is used when determining the turnover of the entity (as opposed to statutory income) and therefore capital gains and income derived outside the course of the business are excluded from the turnover calculation. Assuming the conditions to the application of the $2 million turnover test have been met, it will enable an asset-rich group with a low turnover to access the small business concessions. In light of the preconditions, the $2 million turnover test will most often apply in relation to a taxpayer seeking to dispose of goodwill and other active assets directly held in the taxpayer trading entity.

The other basic conditions for relief include the requirement that a CGT event has happened to a CGT asset (ie an active asset) and that the CGT event would result in a capital gain if it were not for the provisions of Div 152.

Small business 50% active asset reduction

Where the basic conditions for relief have been met, the small business 50% active asset reduction on the amount of any capital gain will be available.

Small business retirement exemption

In addition, the small business retirement exemption may also be available when, in addition to the basic conditions for relief, the requirements of Subdiv 152-D are met. The subdivision provides that, where the taxpayer choosing to access the exemption is a trust, the significant individual test and the trust conditions outlined in s 152-325 must be satisfied.

- The significant individual test requires that, just before the CGT event, the taxpayer has at least one significant individual. A significant individual, in relation to a trust in which there is no fixed entitlement to income and capital, is a natural person who, in the income year during which the CGT event occurs, has a small business participation percentage of at least 20% in the trust in that income year.
- A small business participation percentage is defined as the combination of an individual's direct and indirect participation percentages in the trust. Those participation percentages are effectively the extent to which the individual participates, directly and indirectly, in the income or capital of a trust.
- Where the percentages differ in relation to those various categories of entitlement in the one entity, then it is the smallest percentage that applies. For non-fixed trusts (such as a discretionary trust), it is only where the trust makes a distribution of income or capital in the relevant year that the percentage of that distribution received by the individual as compared to all distributions of that amount made that is to be included in the calculations. For example, if a discretionary trust does not distribute any capital but does distribute $100 in income to which an individual is directly and/or indirectly beneficially entitled to $20, that individual would have a participation percentage of 20%. Alternatively, if, in addition to the income distribution, the trust distributed $100 in capital to which the individual is directly and/or indirectly beneficially entitled to $10, the individual would have a participation percentage of 10% (the smaller of the two potential participation percentages).
- To reiterate, for the small business retirement exemption to be available, the significant individual test need only be satisfied "just before the CGT event". Any pattern of distributions from a trust occurring in years prior to the year in which a business asset is sold will be irrelevant when determining whether the significant individual test has been satisfied.

The trust conditions outlined in s 152-325 that must be satisfied include the requirement that a payment must be made to at least one of the trust's CGT concession stakeholders. A CGT concession stakeholder in a trust in which there is no fixed entitlement to income and capital is a significant individual and a spouse of a significant individual, if the spouse is beneficially entitled to a distribution of income or capital made by the trust in the income year during which the CGT event occurs. The payment is deemed to be made in consequence of the termination of employment of the stakeholder.

Finally, the trust conditions require that the payment be made by the later of two times: seven days after a taxpayer makes the choice to access this exemption, or seven days after the taxpayer receives an amount of capital proceeds from the CGT event.

Where the small business retirement exemption does apply, the payment of the CGT exempt amount to a person who has attained 55 years of age will be exempt from tax. Where the individual is under 55 years of age, the amount of the payment must be rolled over to a superannuation fund.

Small business roll-over

The small business roll-over is set out in Subdiv 152-E ITAA97. This subdivision provides that the roll-over is available so long as the basic conditions of Subdiv 152-A are met. The roll-over allows all or part of a capital gain to be disregarded.

Specific provisions then operate to impose a tax liability if a replacement asset is not chosen, or there is insufficient expenditure on the replacement asset or if the asset doesn't satisfy certain criteria at the end of the period of two years after the time of the original CGT event.

Small business 15-year exemption

A condition for accessing this exemption is that the relevant entity has a significant individual for a total of at least 15 years during the period which the entity owned the asset, and that the entity owned the asset for a continuous period of 15 years, ending just before the relevant CGT event.

The exemption previously required identification of a controlling individual, and therefore had little scope outside of unit trusts or corporate structures where the same individuals have held 50% or greater of the shares or units over a 15-year period. However, with the recent amendments applying from 1 July 2006 now only requiring a significant individual, the exemption has much greater potential application.

Benefit of partnership of discretionary trusts as compared to a hybrid trust

One reason why the partnership of discretionary trusts structure is to be preferred over the hybrid trust structure is that the partnership of trusts structure enables maximum access to the small business CGT concessions.

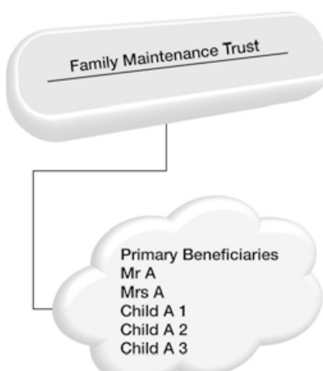
A hybrid trust is a single entity for the purposes of applying the various CGT concessions but, under a partnership of discretionary trusts, each discretionary trust partner separately applies the CGT concessions to determine its own tax liability (and the liability of its beneficiaries) in respect of any capital gain made on the disposal of a business. Under a hybrid trust, there will be a maximum of eight CGT concession stakeholders capable of benefiting from the small business retirement exemption whereas, under a partnership of discretionary trusts, each discretionary trust partner may have up to eight CGT concession stakeholders who are capable of benefiting from the exemption.

As the small business retirement exemption allows each CGT concession stakeholder to take an amount of up to $500,000 (ie their lifetime limit) exempt from tax (subject to the roll-over of the amount of the exemption to a superannuation fund if the individual is under 55 years of age), the number of occasions on which the exemption may apply is not limited.

A further significant advantage of the partnership of discretionary trusts as compared to a hybrid trust is the ability for each discretionary trust partner in the partnership of trusts to make its own family trust election, choosing a member of its own relevant family as a test individual. A hybrid trust, being a single entity, could only make one such election, meaning that, where multiple families are involved, it will not be practical to make such an election. There is further discussion on the importance of the family trust election earlier in this detailed guide on the operation of the partnership of trusts.

¶3-145 The family maintenance trust

The family maintenance trust deed is the same as a standard discretionary trust, except to the extent that this detailed guide illustrates differences. Therefore the key points guide and detailed guide for the discretionary trust should also be referred to in considering the operation of this trust.



The trust is designed to take advantage of s 102AG ITAA36 which provides, subject to certain requirements, that income derived by a trustee from the investment of any property transferred to the trustee for the benefit of certain beneficiaries as a result of a family breakdown is "excepted trust income". Excepted trust income is income which is taxed at ordinary adult marginal rates and is an exception to the usual provision whereby the income of a minor (other than income arising from the personal exertion of that minor) is effectively taxed at a penalty rate.

In addition to the "excepted trust income" benefit, other advantages of family maintenance trust include:

- asset protection;
- the trustee can choose to distribute income to the beneficiaries, or accumulate or reinvest it, after the trustee is assessed on the excepted trust income;

- the opportunity to invest the tax savings each year and benefit from compound growth; and
- if the assets include shares in a company or units in a unit trust controlled by a parent, the beneficiary (once the interest is vested) can have an interest in the underlying family business, thus providing succession planning opportunities.

Excepted trust income

Briefly, the requirements are:

- persons who were married or living in a de facto relationship have ceased to live together, or when the relevant child is born the natural parents were not living together;
- in the first situation, at least one of those persons is the natural or adopted parent or step-parent or has legal custody or guardianship of the minor(s)/beneficiary(ies) — in the deed these persons are referred to as the primary beneficiaries;
- an order, determination or assessment of a court, person or body is made wholly or partly because those persons have ceased to live together or are not living together. In practice, where the child is born after October 1989 or where the parents separated after that date, only an assessment by the Child Support Agency is available. Older children of long separated couples may be the subject of court orders for maintenance. The obtaining of an assessment by the Child Support Agency is, accordingly, essential to satisfy s 102AG as an agreement between the parties is not sufficient;
- the effect of the order, determination or assessment is that a person (whether one of the parents, the trustee or any other person) becomes subject to a legal obligation to maintain, transfer property or do some other thing for the benefit of the primary beneficiaries;
- some property is transferred to the primary beneficiaries or to the trustee for their benefit in giving effect to the legal obligation under the order, determination or assessment; and
- the primary beneficiaries will, under the terms of the trust, acquire the trust property beneficially when the trust ends.

The recitals to the trust deed are tied into these requirements.

Stamp duty

There are provisions in the *Duties Act 2000* (Vic) exempting from duty certain instruments of settlement arising "as a result of the breakdown of the marriage *or domestic relationship of the settlor*" and from certain transfers of shares and land to a family maintenance trust.

For the exemptions to apply:

- there must have been a marriage or domestic relationship;
- one of the parties to the marriage or domestic relationship must be the settlor (and that person could not be the trustee); and
- the beneficiaries must be limited to the parties to the marriage or domestic relationship and the children of either party.

A family maintenance trust deed may be drafted on the basis that the duty exemptions will *not* be sought (but can be restructured so that the exemptions can be sought if so desired). The discussion in this guide considers a trust structure that has not been drafted to achieve the stamp duty exemption, but instead is intended to maximise the availability of the income tax exemptions while retaining as much flexibility in the operation of the trust as possible.

You should examine, or seek professional advice in respect of, the stamp duty legislation in your state prior to the establishment of a family maintenance trust.

Capital gains

While the income tax legislation provides for capital gains tax roll-over relief on transfers of property on relationship breakdowns, there is no roll-over relief on the transfer of property to a family maintenance trust. As such, you should seek professional advice in respect of the capital gains tax consequences of such a transfer.

Structure of the family maintenance trust

It is anticipated that the trustee will be a company but this is not essential. However, as the ITAA36 refers to the "transfer" of property as being an essential requirement, there must be a transfer of property.

There are two classes of beneficiaries:

- primary beneficiaries — these are the children in respect of whom an order, determination or assessment for maintenance has been made; and
- general beneficiaries — these may be anybody else except the settlor. General beneficiaries are entitled to income only and appropriate general beneficiaries might be any other children or step-children of the non-custodial parent/transferor or any spouse or ex-spouse (legal or de facto) of that person.

The income of the family maintenance trust is payable first to the primary beneficiaries in accordance with their entitlement to income under the order, assessment or determination. Any surplus income in any year may be paid to such of the primary beneficiaries or general beneficiaries and in such proportions as the trustee may determine or it may be accumulated.

The capital of the family maintenance trust fund is held in trust for the primary beneficiaries on the termination date. If there is more than one primary beneficiary, a division is made equally between them as tenants-in-common. If any primary beneficiary has died before the termination date, their share will form part of their estate.

The termination date is the end of the relevant perpetuity period (80 years) or such earlier date as the trustee may determine. In an attempt to overcome the rule in *Saunders v Vautier* that a beneficiary absolutely entitled may call for transfer to him or her of the capital on attaining the age of 18, the power to distribute surplus income to general beneficiaries may be included in the trust deed. It is at least arguable that the discretionary interest of general beneficiaries in certain income of the trust means that the primary beneficiaries are not entitled to call for a transfer to them of the capital before the termination date. This gives the trustee the flexibility to keep the trust going beyond the date on which the primary beneficiaries attain the age of 18.

The powers of the trustee include the broad range of powers normally found in discretionary trust deeds. The power of variation is restricted to prohibit any amendment which would alter the entitlement of the primary beneficiaries to priority in income distribution and the capital on termination.

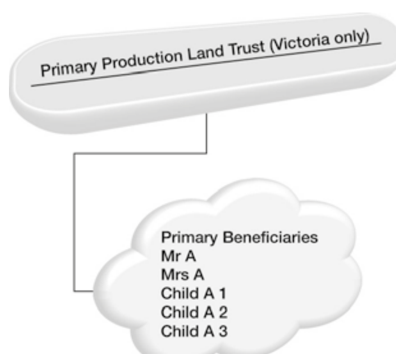
The deed provides for an appointor (which would normally in the first instance be the non-custodial parent) and, for asset protection purposes, it is recommended that an independent person also be appointed. In drafting the appointor provision, consideration needs to be given to the person or persons to whom that power of appointment should pass after the death of the initial appointor.

When completing the deed, details of the order, determination or assessment need to be included.

It should finally be noted that the excepted trust income under this provision of s 102AG is that which "is derived by the Trustee … from the investment of any property transferred to the Trustee". Taken literally, this would mean that the only property which could be transferred is money, which is clearly not the intent of the legislation.

¶3-150 The primary production land trust (Victoria only)

The primary production land trust is identical to a standard discretionary trust, except to the extent that this detailed guide illustrates differences. Therefore, the key points guide and detailed guide for the discretionary trust should also be referred to in considering the operation of this trust.



Section 56 of the *Duties Act 2000* (Vic) provides for an exemption on a transfer or conveyance of land used for primary production (being land referred to in s 65, 66 or 67 of the *Land Tax Act 2005*) where both the transferor and the transferee satisfy certain requirements.

The transferor must be:

(1) one or more natural persons;

(2) a company (not acting as a trustee) in which all the shares are owned by natural persons who are relatives of each other; or

(3) a trustee under a discretionary trust, the capital beneficiaries of which are limited to natural persons who are relatives of each other; or under a fixed trust, the beneficiaries of which are limited to natural persons who are relatives of each other.

The transferee must be:

(1) a relative of a natural person referred to in A;

(2) a trustee under a fixed trust, the beneficiaries of which are limited to present or future relatives of a natural person referred to in A or such persons together with one or more natural persons referred to in A at a charitable institution or any combination of such persons and a charitable institution;

(3) a trustee under a discretionary trust, the terms of which do not allow the distribution of any part of the capital of the trust that is land (referred to in s 65, 66 or 67 of the Land Tax Act) to any person or body other than those in B2; or

(4) one or more natural persons referred to in A2 or 3.

The primary production land trust deed is designed to meet the transferee requirements set out in B3 although references to charitable institutions may not be included for the purpose of simplicity. In most cases the transferor will be as described in A1 or A2. The primary production land trust deed has not been designed to satisfy the A3 transferor requirements and accordingly, once land has been transferred to the trust the s 56 exemption will not be available if it is later desired to transfer the land out of it. However, the s 36A exemption may be available. The A3 transferor requirements are very restrictive in that the whole trust fund is limited as to capital beneficiaries (not just the land) and there is a problem if the trust is to continue past the second generation as third generation beneficiaries (being first cousins) will not be "relatives" of each other as defined.

Features of the deed

The primary production land trust is established by settlement by an independent settlor in the same manner as an ordinary discretionary trust.

Land used for primary production (the property) is transferred to the primary production land trust and the person who is transferring the land is referred to as "the transferor". It is assumed that the transferor is one or more natural persons not acting in the capacity of a trustee (although the exemption is also available when the transferor is as described in A2 and A3 above).

Two classes of beneficiaries

Primary beneficiaries — these must be specified in the schedule and will usually be the transferor and present or future relations of the transferor. The primary production land trust deed provides that no part of the capital of the trust fund which is primary production land can be distributed to any person other than the transferor at a present or future "relative" (as defined) of the transferor.

For this purpose, a relative of the transferor means a person who is:

- a child or remoter lineal descendant of the transferor or of the spouse or domestic partner of the transferor;
- a parent or remoter lineal ancestor of the transferor or of the spouse or domestic partner of the transferor;
- a brother or sister of the transferor or of the spouse or domestic partner of the transferor;
- the spouse or domestic partner of the transferor or a spouse or domestic partner of any person referred to in the dot points immediately above;

- a child of a brother or sister of the transferor;
- a child of a brother or sister of the spouse or domestic partner of the transferor;
- a brother or sister of a parent of the transferor; or
- a brother or sister of a parent of the spouse or domestic partner of the transferor.

General beneficiaries — these include the primary beneficiaries and the full range of general beneficiaries, as set out in the usual form of discretionary trust deed. Because of the limitations imposed by s 56, general beneficiaries do not satisfy the "relatives" test and are not entitled to a distribution of capital that comprises, in whole or part, the primary production property held in the trust. However, they are entitled to distributions of capital from other sources and to distributions of income, subject, of course, to the trustee exercising its discretion to make a distribution to them. Hence there are separate provisions in the deed for the distribution of the primary production property and for the distribution of other capital.

Not sure which structure to use? Use the chart at ¶2-110.

Trustee's discretion

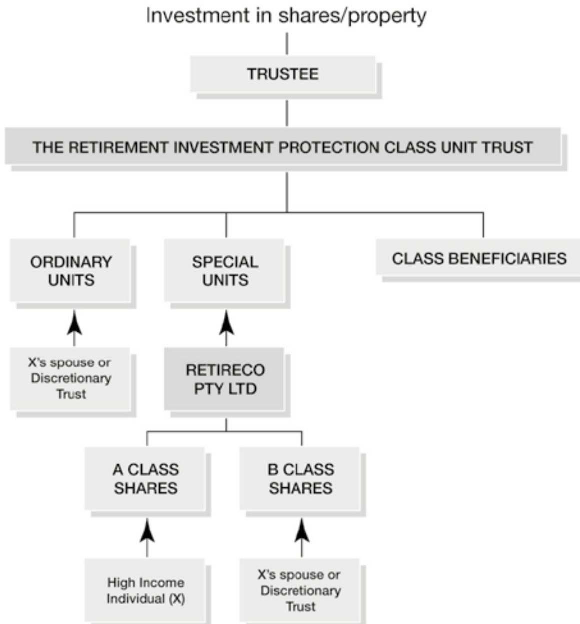
The trustee has a full discretion among the primary and general beneficiaries on the distribution of income.

The schedule provides the option of specifying that the named Primary Beneficiaries are to take the capital of the trust in specified shares when it is wound up. If that is not specified the trustee has a full discretion as to capital distribution, save for the restriction which applies to capital which is primary production land.

It should be noted that the range of persons who may be primary beneficiaries includes future relatives of the transferor — so that, for example, a provision can be made for a gift to unborn children of a child if that child dies before the trust is wound up. If the shares or proportions are not specified and the trustee fails to make a determination by the vesting date, it will vest in such of the primary beneficiaries as are then alive equally between them.

It may be appropriate in some cases to prepare a deed of family arrangement to set out the manner in which the trust is to be administered.

¶3-155 The retirement investment protection class unit trust

<table>
<tr><td rowspan="6">Key points guide</td><td>Diagram</td><td colspan="2">

Note: More comprehensive diagrams are provided in the detailed guide.</td></tr>
<tr><td>Suggested application</td><td colspan="2">To allow a high risk, high-income individual to indirectly invest in income producing passive investments such as property or shares, achieve significant asset protection and may provide an opportunity to deduct interest on borrowings used to invest in the structure.</td></tr>
<tr><td rowspan="4">Parties</td><td>Who is the legal owner of the assets and makes decisions on a daily basis?</td><td>The trustee</td></tr>
<tr><td>Who owns a beneficial interest in the assets?</td><td>Unitholders</td></tr>
<tr><td>Who establishes the structure?</td><td>Unitholders by subscription</td></tr>
<tr><td>Who appoints the legal owner?</td><td>The appointor (conditional)</td></tr>
</table>

Key points guide	Rights under the structure	The trust	Ordinary units	■ The right to receive a portion of assessable income of the trust that is equal to the ratio of issued ordinary units to issued units. ■ The right to one vote per unit held. ■ The right to receive a portion of the capital of the trust that is equal to the proportion which the amount subscribed for issued ordinary units represents of the aggregate of the amount subscribed for issued units.
			Special units	■ The right to receive a portion of assessable income of the trust equal to the proportion which the issued special units represents of the total issued units. ■ The right to one vote per unit held. ■ The right to receive a portion of the capital of the trust that is equal to the proportion which the amount subscribed for issued special units represents of the aggregate of the amount subscribed for issued units. ■ When a disentitling event happens, special unit rights are forfeited. The trustee can then distribute all income (and/or capital) to which the special unitholders would have otherwise been entitled to the class beneficiaries.
			Class beneficiaries	■ In the event of a disentitling event occurring, they have the right to receive all income (and/or capital) that the special unitholders would have otherwise been entitled to receive.
		Retireco Pty Ltd	A class shares	■ Before a disentitling event happens, they have a right to receive all dividends of Retireco and all surplus assets of Retireco when Retireco is wound up; they receive dividends and assets proportionately to their shareholding. ■ Before a disentitling event happens, they have a right to one vote per share held. ■ After a disentitling event happens, all A class share rights are forfeited to the B class shareholders.

Key points guide			B class shares	■ Before a disentitling event happens, they have no voting rights. ■ After a disentitling event happens (see above), they have a right to one vote per share held and a right to receive all dividends of Retireco and all surplus assets of Retireco when Retireco is wound up proportionately to their shareholding.
		Note: A disentitling event is, in effect, high-income individual (X) committing an act of bankruptcy.		
	How does the structure work?	1. X borrows funds from a bank. 2. X uses the borrowed funds to directly subscribe for A class shares in Retireco Pty Ltd. (Note: there will also be a nominal number of B class shares to be held by X's spouse, or an associated discretionary trust). The shares in Retireco Pty Ltd will be a direct investment of X in respect of which X will derive income in the form of franked dividends. 3. Retireco Pty Ltd uses the funds from the share subscription to subscribe for special units in the Retirement Investment Protection Class Unit Trust (the Trust). (Note: there will also be a nominal number of ordinary units in the Trust held by X's spouse, or an associated discretionary trust). 4. The Trust uses the funds from the unit subscriptions to acquire passive investment assets, such as shares or real estate from which income will be derived and distributed to unitholders. 5. To secure payment of the loan made to X described in item 1 above, the Trust may mortgage the passive investment it holds to the bank. Note: there can be difficulty in obtaining finance where third party security is provided. 6. Interest in respect of the borrowing by X may be deductible if the investment is made in the expectation that dividends will be received and that ultimately, the total amount of the dividends will exceed the total of the deductions claimed against assessable income.[5]		

<table>
<tr><td rowspan="2">Key points guide</td><td>Asset protection</td><td>

- The Trust is protected from claims by creditors of those who hold interests in the Trust (unitholders/beneficiaries).
- The share classes in Retireco Pty Ltd and the rights attaching to units in the Trust offer a significant asset protection mechanism, because in the event of an act of bankruptcy in respect of X (a “disentitling event”):
  - X automatically loses his/her right to vote and to receive further dividends from Retireco Pty Ltd;
  - indirectly, the assets of the Trust are protected, in that a trustee in bankruptcy will no longer be able to use the majority A class shares to gain access to the investment assets of the Trust;
  - the rights attaching to the special units will be forfeited to the trustee of the Trust. Thereafter, the trustee of the Trust is empowered to distribute all income and/or capital otherwise distributable in respect of the forfeited special units, to the class beneficiaries.
- Unitholders/beneficiaries are protected from claims by creditors of structure.

Note: the availability of asset protection is based on the structure itself. Care should always be taken to review loans/entitlements that may exist between the various parties, including personal guarantees that may have been given.
</td></tr>
<tr><td>Income taxation</td><td>

- Income accumulated by the structure will be taxed at the highest marginal income tax rate plus the Medicare levy (46.5%).
- Flow-through taxation applies, so that income distributed by the trust will be taxed in the hands of the recipient at their income tax rate. In the case of Retireco Pty Ltd, this will be at the company tax rate of 30%.
- Prior to a disentitling event, the taxable income will be distributed in accordance with the unitholders’ proportionate share of income.
- Retireco Pty Ltd may retain the after-tax profits or pay a franked dividend.
- Prior to a disentitling event, all dividends paid by Retireco Pty Ltd must be paid to the A class shareholders (usually X), who will then either pay additional “top-up” tax or receive a tax refund — depending on the marginal tax rate of the A class shareholder in the year in which the dividend is received and the extent to which the dividend is franked.
- It is recommended that franked dividends be periodically paid to the A class shareholders in order that the A class shareholders may continue to deduct interest expenses they may have incurred in making the investment in the A class shares.[5]
</td></tr>
</table>

Key points guide	Capital gains tax concessions to the trust		50% discount	✓ Available but may be effectively lost when net capital gain is distributed to Retireco Pty Ltd
		Small business concessions	50% active asset reduction	✓ Available (but the benefit is reduced by CGT event E4 if the amount is not distributed to class beneficiaries)[1]
			15-year exemption	✓ Available (if there is a significant individual[2] throughout a total of 15 years)
			Retirement exemption	✓ Available (if there is a significant individual[2] in year of disposal)
			Roll-over	✓ Available
	Capital gains tax concessions to unitholders		50% discount	✓ Available ✗ Not available to Retireco Pty Ltd
		Small business concessions	50% active asset reduction	✓ Available
			15-year exemption	✓ Available (note the test period)
			Retirement exemption	✓ Available
			Roll-over	✓ Available
			Note: small business CGT concessions are only available to a unitholder that is: 1. an individual who is a CGT concession stakeholder[3] in the trust; or 2. an entity in which CGT concession stakeholders[3] of the trust have an aggregate small business participation percentage[4] of 90%.	
		Note: the availability of CGT concessions only relates to the availability to the structure. Consideration must be given to the requirements for accessing the concessions outlined in the ITAA97, and the requirement to distribute amounts of net capital gains in some circumstances to avoid the benefit of the concession being eroded by the gross-up rules in Subdiv 115-C ITAA97.		
	Succession planning (estate planning)	■ The assets of the structure are not owned by any one unitholder, shareholder or class beneficiary and do not form part of an individual unitholder, shareholder or class beneficiary's estate on their death — although units and shares may form part of that estate. ■ Control of the trust resides with the unitholders who, by resolution at a meeting, may remove and appoint trustees. ■ Consideration should be given to which individual(s) or entity(ies) should hold the units. ■ If a disentitling event occurs, the ability to remove and appoint trustees passes to the appointor.		

Key points guide		
	New investors	This structure is established for the purpose of one family group. It is not appropriate for a structure where future investors are contemplated. You should contact your professional adviser to discuss your requirements if you consider new investors to be a possibility.
	Other issues	Particular attention should be given to the issues raised in the detailed guide which include: ■ income on retirement; ■ interest deductions;[5] ■ prepaid deductions in respect of the interest amounts; ■ value shifting on the occurrence of an "act of insolvency"; ■ the ability of the trustee of the Trust to mortgage the investments to secure the original loan made to X; ■ the requirement to stream the non-assessable component of a capital gain with the assessable component of a capital gain as a result of the new Div 6E needs to be taken into consideration when determining to utilise this structure;[6] ■ the validity of the structure under the *Bankruptcy Act 1966*; and ■ the application of Div 7A to loans made by Retireco Pty Ltd to shareholders or associates of shareholders in Retireco Pty Ltd.

1 Refer to "The CGT event E4 problem" in ¶7-105.

2 A "significant individual" is an individual who has a small business participation percentage[4] in the trust of at least 20% (see s 152-55 ITAA97).

3 A "CGT concession stakeholder" is a significant individual[2] of the trust or a spouse of the significant individual,[2] if the spouse has a small business participation percentage at that time greater than zero (see s 152-60 ITAA97).

4 The meaning of "small business participation percentage" is outlined in ¶3-110 of this guide.

5 Refer to "Tax deductibility of interest incurred to acquire an interest in a trust" in ¶7-145 of this guide.

6 Refer to the *Tax Laws Amendment (2011 Measures No. 5) Act 2011* in ¶6-160 of this guide.

Detailed guide — the retirement investment protection class unit trust

General background – the retirement investment protection class unit trust structure

The retirement investment protection class unit trust structure is a specialist structure through which a high income individual ("X") may be able to:

- indirectly, accumulate passive investments (such as shares and/or real estate) for the purpose of deriving income both before and during retirement;
- derive tax effective income in the form of franked dividends from a company (such as Retireco Pty Ltd in the key points guide) which invests in the retirement investment protection class unit trust (the class unit trust) that holds investments such as shares and real estate;
- claim income tax deductions in respect of interest outgoings on borrowings used to subscribe for shares in a company (such as Retireco Pty Ltd); and

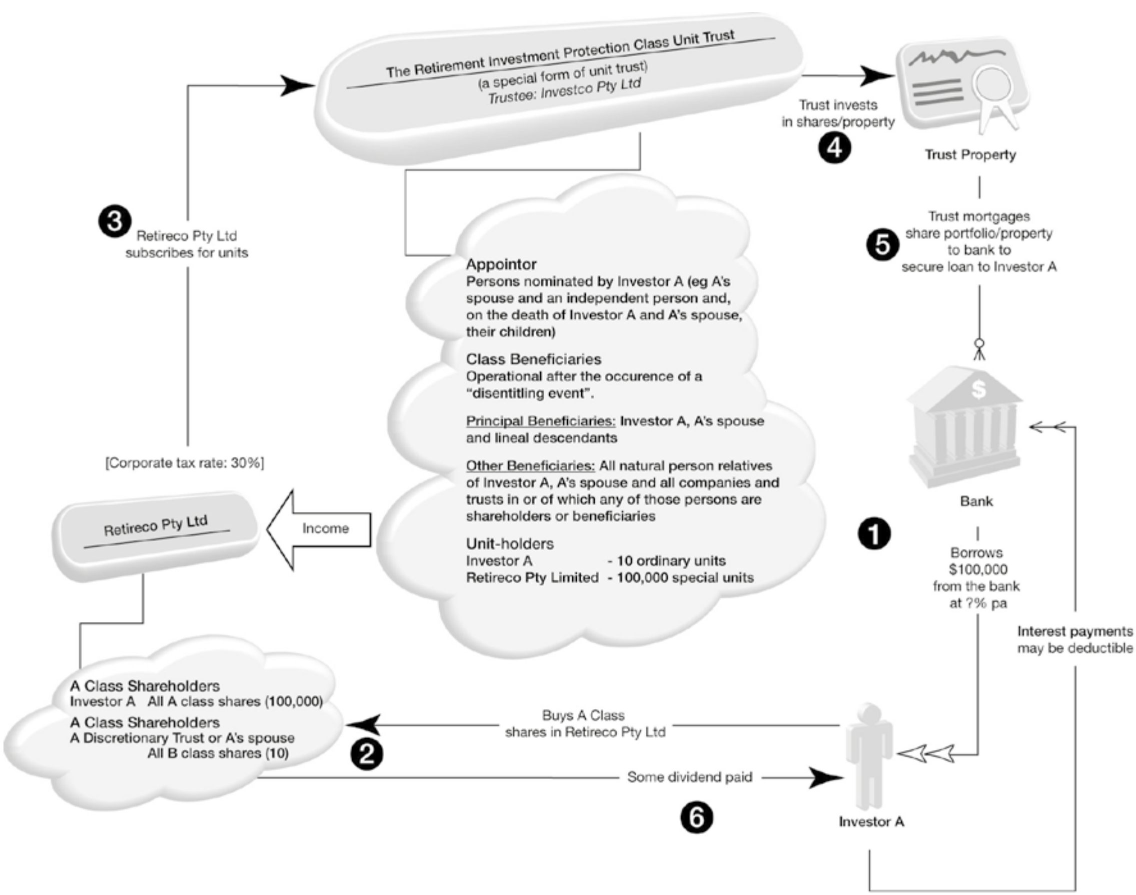
- protect X's investments by automatically being disentitled from receiving future income or any capital (including a return of capital subscribed) in the event that an act of insolvency occurs (ie X becomes bankrupt).

In the scenario outlined in the key points guide, the indirect investment in the class unit trust by X occurs as follows:

X borrows funds for the purpose of subscribing for A class shares in Retireco Pty Ltd. The issued A class shares in Retireco Pty Ltd are X's "direct" investment, in respect of which X will derive income in the form of franked dividends.

A person or entity not exposed to risk, such as X's spouse or associated discretionary trust, subscribes for a nominal number of B class shares in Retireco Pty Ltd.

The retirement investment protection class unit trust structure diagram



- Retireco Pty Ltd then uses the funds from the share subscription to subscribe for special units in the class unit trust.
- X subscribes for a nominal number of ordinary units in the class unit trust.
- The trustee of the class unit trust, Investco Pty Ltd, then uses the funds from the unit subscriptions to acquire passive investment assets such as shares or real estate, from which income will be derived and distributed to unitholders such as Retireco Pty Ltd.

Further characteristics of this structure are as follows:

- To secure payment of the loan made to X, the unit trust mortgages the passive investment assets it holds to the lender.
- As X borrowed funds to acquire income producing assets in the form of shares in Retireco Pty Ltd, the interest on the borrowings may be tax deductible to X.

For further information on the deductibility of interest, see “Interest deductibility” at ¶7-145.

Structure of the entities

Summary of basic entities

Entity	Structure		Rights attaching	Players
Retirement investment protection class unit trust	Trustee		In the event of a disentitling event occurring the trustee has a discretionary power to distribute the special unitholders’ proportionate share of income (and/or capital) to class beneficiaries, in such portions and to such class beneficiaries as it sees fit. Note: A disentitling event is, in effect, X committing an act of bankruptcy.	Investco Pty Ltd
	Appointor		Power to remove the trustee and appoint a new trustee only when a disentitling event happens and there are no other unitholders.	Persons nominated by the high-income individual (X) (eg X’s spouse and/or one or more of X’s siblings and, on the death of X and X’s spouse, their children)
	Class beneficiaries	Principal beneficiaries	In the event of a disentitling event occurring, beneficiaries may receive distributions of all income (and/or capital) that the special unitholders would have otherwise been entitled to receive. Note: A disentitling event is, in effect, X committing an act of bankruptcy.	X, X’s spouse and X’s lineal descendants
		Other beneficiaries		Relatives of X and of X’s spouse and all companies and trusts of which any of those persons are shareholders or beneficiaries

Entity	Structure		Rights attaching	Players
Retirement investment protection class unit trust	Unitholders	Special units	A right to receive a portion of assessable income equal to the proportion which the issued special units represents of the total issued units. A right to one vote per unit held. A right to receive a portion of the capital equal to the proportion which the issued special units represents of the total issued units. When a disentitling event happens, these rights are forfeited. The trustee can then distribute all income (and/or capital) to which the special unitholders would have otherwise been entitled to the class beneficiaries. Note: A disentitling event is, in effect, X committing an act of bankruptcy.	Retireco Pty Ltd: 100,000 special units (In this example, there are 100,000 issued special units and 100,010 issued units, so Retireco Pty Ltd is entitled to 100,000 out of every 100,010 parts of the assessable income)
		Ordinary units	A right to receive a portion of assessable income equal to the proportion which the issued ordinary units represents of the total issued units. A right to one vote per unit held. A right to receive a portion of the capital equal to the proportion which the issued ordinary units represents of the total issued units.	X's spouse or an associated discretionary trust: 10 ordinary units (In this example, there are 10 issued ordinary units and 100,010 issued units, so X's spouse or the associated discretionary trust is entitled to 10 out of every 100,010 parts of the assessable income) (In this example, the maximum amount of capital returned to X's spouse or the associated discretionary trust is the amount of the capital invested, namely, $10)
Retireco Pty Ltd	Shareholders	A class shares	Before a disentitling event happens, a right to receive all dividends of Retireco Pty Ltd and all surplus assets of Retireco Pty Ltd when Retireco Pty Ltd is wound up (distributions to be proportionate to shareholding). Before a disentitling event happens, a right to one vote per share held. After a disentitling event happens, all rights are forfeited to the B class shareholders. Note: A disentitling event is, in effect, X committing an act of bankruptcy.	X: 100,000 A class shares

Entity	Structure		Rights attaching	Players
Retireco Pty Ltd	Shareholders	B class shares	Before a disentitling event happens, a right to a return of capital only; there are no voting rights or income rights. After a disentitling event happens (see above), a right to one vote per share held, a right to receive all dividends of Retireco Pty Ltd and all surplus assets of Retireco Pty Ltd when Retireco Pty Ltd is wound up proportionate to shareholding. Note: A disentitling event is, in effect, X committing an act of bankruptcy.	X's spouse or an associated discretionary trust: 10 B class shares

Structure of Retireco Pty Ltd

Retireco Pty Ltd is a special private company which has two classes of shares:

- A class shares (the majority of issued shares, usually held by X), which have the following rights that continue to exist so long as there is not a "disentitling event" in respect of an A class natural person shareholder:
  - the right to vote at general meetings;
  - the right to all dividends of Retireco Pty Ltd;
  - the right to a return of capital and to all surplus assets on the winding-up of Retireco Pty Ltd proportionate to shareholding; and
  - on the happening of a "disentitling event" (ie an act of insolvency or the calling of a meeting of creditors) in respect of that natural person shareholder, all the above rights attached to the A class shares are automatically forfeited to the B class shareholder(s).
- B class shares (usually held by X's spouse or an associated discretionary trust), which have the following rights:
  - if there is no "disentitling event", B class shares have the right to the return of capital on the winding-up of the company only; and
  - if any A class shares are held by a natural person and a disentitling event occurs in respect of that person, the following rights will attach to the B class shares:
    - the right to vote at general meetings;
    - the right to all dividends of the company; and
    - the right to a return of capital and all surplus assets on the winding-up of the company, proportionate to shareholding.

The particular characteristics of the above share classes in Retireco Pty Ltd offer a significant asset protection mechanism because in the event of a "disentitling event" (an act of insolvency in respect of X):

- X automatically loses the right to receive further dividends from Retireco Pty Ltd; and
- indirectly, the assets of the class unit trust are protected in that a trustee in bankruptcy will no longer be able to use the majority A class shares to gain access to the investment assets of the class unit trust.

Retirement investment protection class unit trust structure

The class unit trust is a specialist unit trust that has two types of units:

- special units (described further in the table above at page 165); and
- ordinary units (described further in the table above at page 165).

In addition, the unit trust has class beneficiaries.

Under a unit trust structure, a trustee holds property on trust for various unitholder beneficiaries who have a beneficial interest in the assets of the trust, proportionate to their unitholding.

A unit trust with unitholders differs from a company with shareholders in a number of respects:

- A company is a separate legal entity which can sue and be sued, while a unit trust is not a separate legal entity and cannot be sued directly. If any action is taken against the trust, it is the trustee that needs to be sued and it is the trustee that incurs and bears the liabilities of the trust.
- Shareholders in a company have no legal title to or beneficial interest in the assets of the company. Rather, their legal title is in regard to the shares that they own. Legal and beneficial title in the company's assets rest with the company as a separate legal entity. Unitholders, on the other hand, have an equitable proprietary interest in all the assets of the trust (*Charles v FCT* (1954) 90 CLR 598 at 609). However, this is not to say that unitholders in the unit trust have a proprietary interest in *each* of its assets (*Livingston v Commissioner of Stamp Duties (Qld)* (1960) 107 CLR 411 at 438).
- Capital profit distributions to unitholders by the trustee retain the nature of a capital receipt in the hands of the unitholders, while a similar distribution from a company (prior to liquidation or winding up) is likely to be a dividend and assessable income in the hands of the shareholder, even though it may have been capital in the hands of the distributing company.

Holders of the ordinary units are called ordinary unitholders and holders of the special units are called special unitholders.

Special unitholders are entitled to:

- receive that portion of assessable income of the class unit trust equal to the proportion which the issued special units represent of the issued units;
- one vote per special unit held; and
- receive that portion of the capital of the class unit trust equal to the proportion which the issued special units represent of the issued units.

Ordinary unitholders are entitled to:

- receive that portion of assessable income of the class unit trust equal to the proportion which the issued ordinary units represent of the issued units;
- one vote per unit held; and
- receive that portion of the capital of the class unit trust equal to the proportion which the issued ordinary units represent of the issued units.

The rights attaching to the special units held by Retireco Pty Ltd continue as long as a "disentitling event" does not occur. On the occurrence of a disentitling event, the rights attaching to the special units would be forfeited. After a disentitling event, the trustee may distribute all income (and/or capital) otherwise distributable in respect of the special units to the ordinary unitholders or class beneficiaries.

The class beneficiaries have no fixed entitlement to income or capital of the class unit trust. The class beneficiaries may receive distributions of the income or the capital of the class unit trust in the circumstances outlined above, provided the trustee makes such a determination.

In general, the class beneficiaries will include:

- X, X's spouse and lineal descendants; and
- the relatives of X and X's spouse and all companies and trusts of which any of those persons are shareholders or beneficiaries.

Various commercial and taxation aspects of the class unit trust

Distributions from the class unit trust (general)

As indicated earlier, the nature of capital or income payments made by Investco Pty Ltd (as trustee) to unitholders will be preserved in the hands of the unitholder to whom the distributions are made. This issue is not contentious in regard to income distributions made by Investco Pty Ltd (as trustee). However, certain capital payments by Investco Pty Ltd (as trustee) to unitholders may result in cost base adjustments to the units held by certain unitholders, and in some instances will trigger a deemed capital gain.

Capital payments by Investco to unitholders and/or class beneficiaries

If Investco Pty Ltd (as trustee) incurs a capital gain in respect of a disposal of any of its investments, it will be eligible to claim the 50% CGT discount. However, it is unlikely it will be eligible to claim any of the small business CGT concessions, as it is unlikely the investments held for the benefit of unitholders will satisfy the active asset test in s 152-35 ITAA97. There is one possible exception — land that is used in the conduct of a business by a connected entity (where "connected entity" has the meaning outlined in Div 152 ITAA97). Although classed as a passive asset for the purposes of this guide, the land will be deemed to be an active asset for the purposes of the small business CGT concessions.

If, after claiming the 50% CGT discount and any other available concessions, the class unit trust has a net capital gain, the amount of the net capital gain must be distributed to natural persons within the same financial year as that in which the CGT event generating the capital gain occurred. If the distribution is not made, the 50% CGT discount will not be available to the class unit trust and the corresponding capital gains will be grossed up to their pre-concessionary amount. Furthermore, Investco Pty Ltd will be liable to pay tax on the grossed up capital gain at the highest marginal tax rate.

The payment of the net income of the class unit trust (after claiming the 50% CGT discount) will not result in any cost base adjustments, regardless of whether they are made to the class beneficiaries or to the unitholders.

Where payment of the net capital gain, after application of the 50% CGT discount is made to a company, the amount of the non-assessable distribution will need to be grossed up, because a company is not eligible to claim the 50% CGT discount. Effectively the company will be taxed on the amount of the capital gain without the benefit of the 50% CGT discount.

The payment of the non-assessable component of a capital gain (ie the non-taxable 50% CGT discount amount) to the class beneficiaries (for example after the occurrence of a disentitling event) will not result in any cost base adjustments, since these beneficiaries have no interest in or right to receive distributions from the class unit trust ahead of the unitholders. These class beneficiaries have no more than a mere expectancy, as payments to class beneficiaries are at the absolute discretion of Investco Pty Ltd (as trustee). However, note the potential impact of the new Div 6E (see ¶6-160 of this guide) which requires the non-assessable and assessable component of a capital gain to be streamed together.

Any payment to unitholders of a non-assessable amount representing the 50% CGT discount will not attract the cost base adjustment rules. However:

- The cost base adjustment rules do apply to payments of non-assessable amounts to unitholders to the extent that the non-assessable amount includes the small business 50% reduction.
- The payment of the amount of the small business 50% reduction to unitholders will trigger CGT event E4 and reduce the cost base of the units. Where the amount of the small business 50% reduction exceeds the amount of the cost base of the units, the excess will constitute a capital gain to the affected unitholder. In respect of this "excess capital gain", the following should be noted:
  - where the unitholder is an individual and has held the units for at least 12 months, the unitholder may be entitled to a discount of 50% on any capital gain taken to be made as a result of the cost base adjustment; and
  - where the unitholder is a company (not acting as trustee), the amount of the small business 50% reduction distributed to the company will be taxable and, to the extent the amount of the small business 50% reduction exceeds the cost base of the units, the benefit of the small business 50% reduction will be lost. In addition, the distribution by the company of the amount of the small business 50% reduction will be received by the shareholders of the unitholder-company as an unfranked dividend, where the payment is made prior to liquidation.

A further discussion of these CGT implications is outlined in ¶7-105 of this guide.

Income on retirement

When X retires, X will continue to be entitled to the following:

- fully franked dividends as a pension from Retireco Pty Ltd (provided there is no disentitling event); and
- investment income from the discretionary trust (where the ordinary units in the class unit trust are held by a discretionary trust).

Interest deductibility

The interest payable in respect of the loan used to acquire shares in Retireco Pty Ltd may be deductible to X, provided the interest rate in respect of the loan is at standard commercial rates, the investment is made in the expectation that dividends will be received and that, ultimately, the total amount of the dividends will exceed the total of the deductions claimed. The deductibility of the interest is not dependent on Retireco Pty Ltd actually paying a dividend to X: *FCT v Total Holdings (Aust) Pty Ltd* 79 ATC 4269. In fact, even where the amount of interest is greater than the assessable income and this persists for a number of years, provided the interest has been incurred to produce the assessable income, the interest will be fully deductible (refer to IT 2684, paras 28 to 30). However, in accordance with arm's length commercial arrangements, Retireco Pty Ltd should pay regular dividends to X.

TA 2008/3 "Uncommercial use of certain trusts" was released by the Commissioner on 26 March 2008. TA 2008/3 identifies features of trust arrangements which are of concern to the Commissioner. The terms of this taxpayer alert should be considered when determining the deductibility of interest on the specific facts of each case. Taxpayers must also consider the implications of TD 2009/17 (which is the finalised form of TD 2008/D16). In particular, the Commissioner makes the following statement at para 2 of TD 2009/17:

> *The taxpayer's interest expense can only be deducted to the extent to which the taxpayer has used borrowed moneys to gain or produce assessable income of the taxpayer. The interest will not be deductible to the extent that the taxpayer has used the borrowed moneys for the purpose of benefiting persons other than the taxpayer.*

In relation to variations of the structure described above, the Commissioner may argue that the ability to distribute capital amounts or non-assessable income to ordinary unitholders or class beneficiaries is indicative of a purpose of the individual investing in the A class shares in Retireco Pty Ltd to benefit persons other than the taxpayer investor. Such arguments are at present untested by the courts. The structure described above only permits such discretionary distributions after the occurrence of a disentitling event. It would be rare if not impossible to find a circumstance where a taxpayer invested in a structure in the form outlined above with a purpose of committing an act of insolvency. Taxpayers concerned about the Commissioner's statements in TD 2009/17 could adopt more restrictive forms of trust deeds.

Issues relating to interest deductibility are addressed in more detail in ¶7-145 of this guide.

Prepaid interest deductions for the principal

The 13-month prepayment rule ceased to apply from 1 July 2001. Since that date, individuals incurring deductible non-business expenditure have been able to claim up to 12 months prepaid interest under the 12-month prepayment rule. Under this measure, an immediate deduction for prepayments (such as the interest incurred on the loan used to acquire shares in Retireco Pty Ltd) will be allowed to a taxpayer where:

- the payment is incurred in respect of a period of service (in this instance, the period of the loan to which the interest relates) not exceeding 12 months; and
- the period of service ends after the last day of the income year following the year in which the payment is made (s 82KZM(1)(ba) ITAA36); that is, the period of service ends in the next income year after the year in which the payment is made.

Where these conditions are not met (namely, the service period is longer than 12 months), advance expenditure will be deductible pro rata over the service period or 10 years, whichever is less.

Unless the principal is carrying on the business of buying and selling shares and using finance to make the acquisitions, it may be tax effective for the principal to prepay up to 12 months of interest in respect of the money borrowed to acquire shares in Retireco Pty Ltd, and claim a deduction for that prepaid amount.

Value shifting on the occurrence of an "act of insolvency"

Since 1 July 2002, the value shifting provisions which previously applied only to shares (and certain debt forgiveness situations) have applied equally to other equity interests such as units.

For there to be a direct value shift there needs to be a scheme under which value is shifting from equity in a company or trust to other equity in the same company or trust. In basic terms, the scheme requires involvement of the controller equity holder (majority shareholder or unitholder) and an entity that is an associate of the controller. Examples include issuing new units at a discount, redeeming units or changing the voting rights attached to units.

"Scheme" is defined broadly under the ITAA97 to include, among other things, any arrangement, plan, proposal or course of action or conduct. "Arrangement" is separately defined in s 995-1(1) as "any arrangement, agreement, understanding, promise, or undertaking, whether express or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings".

Under the terms of Retireco Pty Ltd's constitution (and under the terms of the trust deed for the class unit trust), on the occurrence of an act of insolvency, the rights attaching to the shares and units, respectively, held by X, are forfeited to the other minority shareholder or unitholder, which would be an associate of X. The constitution of Retireco Pty Ltd outlines the contractual rights of each shareholder in regard to the company and is, in effect, a contract or agreement between the company and the underlying shareholders. The fact that the constitution has a mechanism which forfeits the rights of X on an "act of insolvency" could constitute a "scheme" for the purposes of the value shifting provisions.

If the view is taken that, on an act of insolvency there is value shift from the A class shares (held by X) to the B class shares (held by X's associate), X will be taken to have derived a capital gain on a deemed disposal of part of X's A class shares. In addition, there may be cost base adjustments for both the A class and B class shares to reflect the fact that, after the act of insolvency, the value of the A class shares is less (due to a forfeiture of dividend and voting rights) and the value of the B class shares is more (due to these shares now having the additional rights). This will equally apply to the units Retireco Pty Ltd holds in the unit trust, the associated rights also being forfeited on an act of insolvency. It could be said that the constitution of Retireco Pty Ltd, and separately the trust deed for the unit trust, fall within the definition of a "scheme" (being agreements) for the purposes of the value shifting provisions.

On the other hand, it could be said that the occurrence of an act of insolvency will not constitute a value shift because there is no variation or change of voting rights associated with the affected shares (or units). It could be submitted that, on the occurrence of an act of insolvency, there is no separate amendment of the constitution or the trust deed to specifically forfeit or change the voting rights associated with the shares or units from the original conditions on which these shares or units were allotted. Rather, the occurrence of an act of insolvency is one of the automatic forfeiture provisions provided for in the originally signed constitution; these provisions would not have changed after establishment of either Retireco Pty Ltd or the class unit trust.

Even if the first view outlined was accepted by a court, and the various de minimus rules and exemptions in the value shifting provisions were not satisfied, it should be noted that the A class shareholder in Retireco Pty Ltd and the special unitholder in the class unit trust will derive the applicable capital gain.

As the A class shareholder and/or Retireco Pty Ltd will be the individual or company involved in the insolvency event (otherwise the value shift would not have been triggered), the incurring of a further liability to the A class shareholder and/or Retireco Pty Ltd at that time may not be a concern.

The ability of Investco Pty Ltd to mortgage investments to secure a loan to the principal

Investco Pty Ltd, as trustee of the class unit trust, can mortgage the investment portfolio to secure the loan made to X to acquire shares in Retireco Pty Ltd. On the basis that Investco Pty Ltd would mortgage the investment (including share) portfolio in its capacity as trustee of the class unit trust, it would not be subject to the provisions of s 260A of the *Corporations Act 2001*, which prohibits a company from providing security to finance dealings in its shares unless certain requirements are satisfied.

The validity of the structure under the Bankruptcy Act 1966

Section 302B provides that:

> *A provision of a trust deed is void to the extent that it has the effect of:*
>
> *(a) cancelling, reducing or qualifying a beneficiary's interest under the trust; or*
>
> *(b) allowing the trustee to exercise a discretion to the detriment of a beneficiary's interest;*
>
> *if the beneficiary becomes a bankrupt, commits an act of bankruptcy or executes personal insolvency agreement under this Act.*

In the event that X becomes bankrupt, this structure will not breach this section and the automatic forfeiture of rights will continue to be effective, regarding both of the shares held in Retireco Pty Ltd and of the units held by Retireco Pty Ltd in the class unit trust. This is because:

- s 302B only applies to any cancellation, forfeiture etc of:
  - first, the rights held by the bankrupt; and
  - second, rights held in a trust;
- under this structure, on the occurrence of a "disentitling event", the forfeiture actually occurs at two levels which do not fall within s 302B:
  - the share-related rights held by X in Retireco Pty Ltd, which is not a trust; and
  - the unit, related rights in the class unit trust itself held by Retireco Pty Ltd as unitholder, which, however, is not the actual bankrupt individual. Retireco Pty Ltd is a separate legal entity from the potential bankrupt.

¶3-160 The testamentary trust

There are three different ways that a person (testator) can arrange for property to be handled after their death. These are compared in this table.

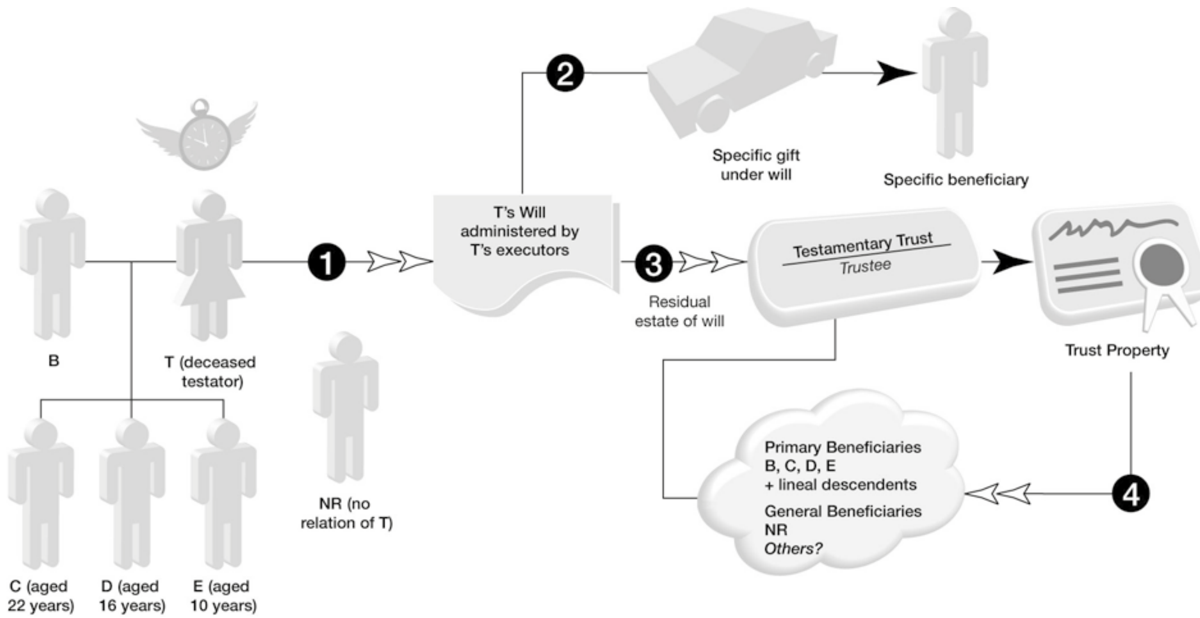
The following table shows differences between a will, an inter vivos trust and a testamentary trust.

	Will	Inter vivos trust	Testamentary trust
General description	In a standard will, the testator leaves his estate in fixed shares for specific beneficiaries. For example, the will may say, "I leave my residual estate to my children who survive me in equal shares". Sometimes, the will provides that if a testator has a child and that child dies before the testator dies, then that child's share of the testator's estate is to be distributed among any grandchildren.	The Latin expression inter vivos means "between living people". An inter vivos trust is a trust established during a person's lifetime. Most of the trusts discussed in this guide are inter vivos trusts.	A testamentary trust is a trust established under a will when the testator dies. It is this establishment on death that distinguishes a testamentary trust from an inter vivos trust. In other respects, a testamentary trust has much in common with an inter vivos trust. The beneficiaries and the discretion given to the trustee as to the distribution of income and capital can be the same in a testamentary trust and an inter vivos trust.
Assumptions	All assets controlled by the testator are owned beneficially by the testator.	The testator has control of a trust (eg a discretionary trust) and has transferred all (or a substantial part) of the testator's assets to the trust before death. On death, the testator has no interest in the assets transferred.	The testator has written a will that provides for a testamentary trust to be established after his death and during the administration of his will. Before his death, the testator is the outright owner of his assets.

	Will	Inter vivos trust	Testamentary trust
Effective document	The will.	The deed establishing the inter vivos trust.	The will and then the terms of the testamentary trust contained in the will.
Effect of death	Before death the testator owns all assets beneficially. On death, the legal ownership of those assets passes to the testator's executors. It is the executor's function to collect all assets and pay all debts of the testator. During this time, the executors hold the assets on trust for the beneficiaries specified in the will. Once the executors have completed the administration of the estate, the legal ownership of the testator's estate is transferred to the beneficiaries.	The testator's death has no effect on an inter vivos trust. The legal ownership of the assets remains vested in the trustee of the trust and the equitable ownership of those assets remains with the beneficiaries under the terms of the trust. If the testator is a trustee or, in fact, the trustee of the trust, the testator's death may require the appointment of a new trustee. However, the rights of the beneficiaries of the trust are not affected.	Before the testator dies, the testator owns the assets in the testator's name beneficially. On the testator's death, the legal interest in those assets passes ① to the testator's executors. It is the executor's function to collect all the assets and pay all debts of the testator. During this time, the executors hold the assets in trust for the testator's beneficiaries as specified in the will. Once the executors have completed administration of the estate (such as by passing a specific gift to a specific beneficiary in the will ②), the legal ownership of the testator's estate is transferred to the trustees of the testamentary trust ③ who then deal with the assets, not in accordance with the terms of the will, but in accordance with the terms of the testamentary trust. The testator's executor or executors may or may not be the same person or persons as the trustee or trustees of the testamentary trust. The trustee deals with the trust capital and income in accordance with the powers given to them under the testamentary trust ④. (Note: Number references are to diagram at page 176).

	Will	Inter vivos trust	Testamentary trust
	Death duties: No. **Stamp duties**: No. There are no stamp duties payable on the transfer of property by will. **CGT**: No. There is no CGT payable on the transfer of property by will. The cost base and time of acquisition rules should be considered separately.	**Death duties**: No. Trusts can outlive persons who establish them and, in any event, only the property dealt with by the will would be subject to any applicable death duties (and there are currently none in Victoria); the property in the trust is not dealt with by the will. **Stamp duties**: Yes. Stamp duty would be payable on the transfer of real property from the transferor owner to the trust (this would be payable on the transfer occurring). No further stamp duty would be payable on death. **CGT**: Yes. The testator would have to pay CGT on any gain realised on the "sale" of his property to the trust. Again, this would be payable only on transfer, not on death and consideration should be given to the availability of the various CGT concessions.	**Death duties**: No. There are currently no death duties in Victoria. **Stamp duties**: Generally no. There are generally no stamp duties payable on the transfer of property from the estate of the testator to the testamentary trust although some State Revenue Offices are reconsidering the applicability of exemptions to duty. **CGT**: No. There is no CGT payable on the transfer of property from the estate of the testator to the testamentary trust. The cost base and terms of acquisition rules should be considered separately.

Diagram showing the workings of a testamentary trust



Asset protection in a testamentary trust

The primary benefit of the ownership of assets by the trustees of a discretionary testamentary trust is that no one beneficiary has any claim on the assets of the testamentary trust. A discretionary testamentary trust, therefore, provides the best means to protect assets which, after death, are to be held for the benefit of the testator's successors (ie spouse and children). For example, assume the trustee of a trust owns an investment property and a beneficiary encounters financial difficulty as a result of the ownership of a failed business. The creditors of the beneficiary cannot seize the assets of the testamentary trust to satisfy the debt as that beneficiary does not have any claim on or ownership of the assets of the testamentary trust (unless there is some money unpaid and owing to him by the testamentary trust).

By way of further example, if the beneficiary is involved in Family Court proceedings, the Family Court cannot direct that the assets of a properly structured testamentary trust be used to satisfy the claim of the spouse in the Family Court property proceedings. A properly structured testamentary trust is one where the appointor provisions are drafted in a particular manner.

Trust assets are not owned by any beneficiary and therefore cannot be passed by will. By appropriate consideration of the appointor provisions, control of the trust, and thereby the trust assets, can be passed to the next generation. For example, the testamentary trust deed can provide that, following the death of the original appointors of the trust, their children become the appointors of the trust. In that way, the testator's grandchildren may obtain control of the testamentary trust following their parents' death, in much the same way as they would if the assets were passed by will directly on their parents' death.

Flexibility of distributing income in a testamentary trust

Another advantage of a testamentary trust is the ability for income or capital of the trust to be distributed between the beneficiaries in the most tax effective manner. The trustee is required to distribute the income in each year between the beneficiaries or to accumulate it (although accumulation may result in more tax being paid on that income). The trustee can elect to distribute that income to any one of the primary or general beneficiaries, none of whom have any enforceable interest to require that a percentage of the income or any fixed sum be paid to them in any year. The trustee has a similar power to distribute capital during the life of the trust.

Taxation of income received by minor beneficiaries of a testamentary trust

A testamentary trust has significant taxation benefits in respect of the taxation of minor beneficiaries. Generally, the unearned income of persons under 18 years has a tax-free threshold of $416 (subject to any applicable low income rebates); after that, all income is taxed at the top marginal rate. Section 102AG ITAA36 provides that income of a trust estate that results from a will is “excepted trust income”. Where excepted trust income is distributed to minor beneficiaries, it will be taxed in the hands of the minor beneficiaries at the normal adult marginal tax rates. This means that each minor beneficiary can receive a tax-free distribution of $18,200 and normal adult marginal tax rates apply after that. If each minor beneficiary receives no additional income and the low income tax offset is available, each minor beneficiary can receive a tax-free distribution of approximately $20,500 subject to application of the Medicare levy (the tax payable on the additional distribution of $2,300 (above the $18,200 tax-free threshold) being equivalent to the amount of the low-income tax offset applicable for the 2012-13 and later years of $445).

The assets of a testamentary trust are not limited to the assets of the estate of the testator. After the testator’s death, the testamentary trust can acquire other assets that create income streams to the testamentary trust. This income may also be excepted trust income and be subject to the same favourable taxation treatment when distributed to minor beneficiaries.

Providing for both the testator’s spouse and children

Generally, a testator will wish to make sure that any surviving spouse is properly looked after with access to such income and capital as they need during their lifetime, with the residue of the estate eventually passing to their children. This can be achieved through the use of a testamentary trust.

Without a testamentary trust, this outcome can be achieved by simply providing in a will that the entire estate passes to the surviving spouse and, if there is no survivor, then directly and equally to the testator’s children in equal shares. The testator relies on the understanding that the spouse will, on their death, leave all the remaining assets to the children. There can be tension in such arrangements if the testator is concerned that the surviving spouse may make a new will at some future time, possibly reflecting a new relationship that excludes the existing children from the benefit of the assets accumulated by the testator and the surviving spouse during their joint lifetimes.

This concern was often reflected in provisions in wills in which a life interest in the estate was granted to a surviving spouse that provided income to the surviving spouse but no right to the capital of the estate. Life estates have adverse CGT implications and can also cause friction between the surviving spouse and the children because of the conflict between the desire of the surviving spouse for income and freedom of choice as to expenditure and the desire of the children to maintain the capital of the estate.

No matter how an estate is dealt with, this conflict can never be totally resolved. A total disposition of assets to the surviving spouse always carries the risk that the children may not ultimately receive assets. If spouses hold assets jointly, then in many cases there will be very few assets in the estate of the first to die, as the surviving spouse will receive the joint assets by way of survivorship. Accordingly, consideration should be given to the manner in which family assets are held when preparing wills.

In a testamentary trust, the primary beneficiaries are usually the surviving spouse, the children of the testator and their lineal descendants (such as grandchildren). The trustee has a complete discretion to decide who receives the income and capital of the testamentary trust. In the same way as an inter vivos discretionary trust, the trustee has discretion to distribute income and capital to the beneficiaries as the trustee sees fit. The discretion is subject only to the power of the appointor to remove the trustee at any time. Accordingly, selection of the most appropriate persons to be the appointors should ensure that the testator's intentions are carried out and the control of the testamentary trust is in appropriate hands.

A testamentary trust can ensure that the surviving spouse has a significant level of control, particularly in concert with an independent third person such as a professional adviser, to ensure that the surviving spouse has full and free access to the income and capital of the testamentary trust during their lifetime. The terms of the testamentary trust could provide that control will effectively pass to the children of the testator on the death of the surviving spouse. To ensure that each of the children of the testator receive their "share" of the testator's estate, the will can establish a separate testamentary trust for each child of the testator with the surviving spouse initially having control of each child's trust.

Even though the primary intention may initially be to provide for a surviving spouse, the trustee of a testamentary trust could, in each and any year, distribute such income as the trustee thinks appropriate to minor beneficiaries of the testamentary trust. The minor beneficiaries would obtain the full benefit of the special taxation treatment of their income provided for in s 102AG ITAA36.

¶3-165 The social security special disability trust

The social security system has historically been a barrier to persons making financial provision for a severely disabled relative, because a gift of assets for the benefit of the disabled relative could reduce the donor, the donor's spouse or the disabled relative's social security entitlements.

The federal government amended the *Social Security Act 1991* (SSA91) to reduce those barriers to encourage immediate family members to establish a special disability trust (SDT) for the care and accommodation of the disabled relative. Special disability trust assets with an aggregate value of up to $626,000 as at 1 July 2014 (indexed annually) (SDT asset threshold) will receive concessionary treatment for social security purposes. The SDT asset threshold was originally set at $500,000 on 20 September 2006.

This chapter addresses the changes to existing social security laws and selected income and CGT consequences requiring consideration when establishing an SDT. Throughout this chapter, references to legislation are references to the *Families, Community Services and Indigenous Affairs and Other Legislation (2006 Budget and Other Measures) Act 2006* (Cth), unless stated otherwise.

Historical social security barriers

SSA91 means tests

A person's disability support pension and carer payment entitlements are subject to an assets means test and an income means test (Pts 3.12 and 3.10 SSA91). Carer payments are also subject to the receiver satisfying the special care receiver income test.

The assets and income of a private trust or company are attributable to each of the persons who control the trust or company, or to each of the persons who were the source of the capital or corpus of the company or trust under the means tests (Pt 3.18, Divs 2 and 3 SSA91).

The income and assets limits that apply at the date of publication are summarised in the following table:

Family situation	For full payment (per fortnight)*	For part payment (per fortnight)#+
Income test		
Single	Up to $152	Less than $1,768.00
Couple (combined)	Up to $268	Less than $2,705.60
Assets test	**(per annum)**	**(per annum)**
Single — homeowner	Up to $192,500	Less than $731,500
Single — non-homeowner	Up to $332,000	Less than $871,000
Couple — homeowner	Up to $273,000	Less than $1,086,000
Couple — non-homeowner	Up to $412,500	Less than $1,225,500

* Income over these amounts reduces the rate of pension payable by 50 cents in the dollar, and 25 cents in the dollar each (for couples). Assets over these amounts reduce pension by $1.50 per fortnight for every $1,000 above the limit.

\# Limits will increase if rent assistance is paid with the pension.

\+ Pharmaceutical allowance included.

The assets means test does not include certain assets, such as a right or interest in a principal home and proceeds from the sale of the principal home (s 1118 SSA91).

Income for the income means test is gross income adjusted by specified SSA91 inclusions and exclusions (*DSS v Reed* (1988) ASCC ¶92-098; *Paula v DSS* (1985) ASSC ¶92-042), and is often different to taxation income, requiring care when calculating entitlements.

Both the income means test and assets means test calculate entitlements, and the test that results in the lower entitlement (or no entitlement) will apply. Entitlements are progressively reduced between the above thresholds, with no entitlement payable whereafter exceeding the part-payment threshold.

Deprivation rules

Where a person disposes of assets for inadequate consideration or with the purpose to obtain a social security entitlement, the value of the disposed asset is included in that person's assets means tests, and the person is deemed to receive income at the statutory rate for the income means test for the following five years (s 1123 SSA91).

The asset deprivation rules apply to any amount gifted in excess of $10,000 in a single year or $30,000 over a rolling five-year period. A disposal by one person of a couple will also affect that person's partner.

Provision for disabled relatives

Prior to 1 January 2002 (when the *Social Security and Veteran's Entitlements Legislation Amendment (Private Trusts and Private Companies — Integrity of Means Testing) Act 2000* (Cth) commenced operation), it was possible to structure assets transferred to or acquired by a disability trust to avoid the means tests and the asset deprivation rules for the donor and for the disabled relative. However, from that date, the donor and the disabled relative's social security entitlements were subject to the deprivation rules and the revised means tests.

From 20 September 2006, the SDT rules constitute a means of assisting persons to provide for a severely disabled relative without reduction in entitlements.

Special disability trusts

Overview

To qualify as an SDT, the trust must:

- have one principal beneficiary (although it can have a residuary beneficiary) (s 1209M(1) SSA91) with a "severe disability";
- be established solely to provide for the care and accommodation needs of the principal beneficiary; (s 1209N SSA91);
- contain the clauses set out in the model trust deed in the establishing instrument (s 1209P SSA91);
- have an independent trustee or more than one trustee (s 1209Q SSA91);
- comply with certain investment restrictions (s 1209R SSA91);
- provide annual financial statements (s 1209S SSA91); and
- conduct independent audits when required (s 1209T SSA91).

The social security advantages of an SDT include:

- transfer of assets by a social security recipient who is a qualified relative to the SDT up to the SDT assets threshold not being subject to the deprivation rules;
- the value of assets not exceeding the SDT assets threshold not being attributed to the donor or the principal beneficiary under the assets means test (s 1209Y(5) SSA91); and
- the income from the assets not exceeding the SDT assets threshold not being attributed to the donor or the principal beneficiary under the income means test.

Where qualified donors make a number of transfers, the aggregated value of the transferred assets applies to the SDT asset threshold (s 1209ZA(2) SSA91). Subsequent transfers that exceed the SDT asset threshold are assessable as assets of the principal beneficiary for the means tests (s 1209Y(2) SSA91) and the deprivation rules will apply (s 1209ZA(1) SSA91).

Transitional measures apply in respect of trusts created before 20 September 2006.

Qualifying principal beneficiary

A principal beneficiary who has reached 16 years old qualifies if the person (s 1209M(2)):

- has an impairment that would qualify that person to receive a disability support pension, or to receive a service pension, or to receive an income support supplement;
- has a disability that would qualify a carer for that person for a carer's allowance; or
- is living in an institution, hostel or group home in which care and funding is provided; and
- is not working and has no likelihood of working for a wage at or above the relevant minimum wage.

If the principal beneficiary is less than 16 years old, the person must have a severe disability or severe medical condition within the meaning of the SSA91 (s 1209M(4) SSA91).

Statutory impairment tables detail the degree of physical, intellectual or psychiatric impairment based on medical, social and work function resulting in a continuing inability to work (s 94 SSA91). The concept of severe disability or severe medical condition is covered in s 197 SSA91.

It is beyond the scope of this guide to discuss the degree of impairment. However, the degree of impairment to qualify is significant.

Qualifying trustees

An individual qualifies to be a trustee if the individual (s 1209Q(1) SSA91):

- is an Australian resident;
- has not been convicted of an offence of dishonest conduct or an offence arising out of the SSA91, the *Veteran's Entitlements Act 1986* or the *Social Security (Administration) Act 1999* (Cth); and
- has not been disqualified from managing a corporation.

If the trustee is a corporation, the above requirements apply to each director of the trustee (s 1209Q(2) SSA91).

Qualifying trust property

The assets of the trust must not include an asset transferred to the trust by the principal beneficiary or his or her partner (unless the transferred asset is a bequest or a superannuation death benefit and the transferor received the asset within three years of the transfer (s 1209R(1) SSA91) or include any compensation received by the principal beneficiary (s 1209R(2) SSA91).

The assets must not be used to pay an immediate family member or child of the principal beneficiary for care services or accommodation or be used to purchase or lease property from an immediate family member or a child of the principal beneficiary (s 1209R SSA91).

When determining the assessable assets of the SDT, the value of any right or interest in the beneficiary's principal home is disregarded (s 1209Y(4) SSA91).

Qualifying asset transfer

If a social security recipient transfers an asset to an SDT (the value of which does not exceed the SDT asset threshold), the transfer is disregarded for the purposes of the deprivation rules.

A transfer qualifies if the donor (s 1209Z SSA91):

- is an immediate family member of the principal beneficiary;
- receives (or the donor's partner receives) a social security or service pension;
- is of pension age;
- does not receive consideration for the transfer; and
- transfers the asset unconditionally.

Where neither the donor nor the donor's partner have reached pension age or are in receipt of a pension, the donor is deemed to have made the transfer at the time that the donor or the donor's partner reaches pension age (s 1209ZB(1) SSA91). Accordingly, donors who do not initially qualify may take advantage of the concessionary measures later when they do qualify.

SDT status cessation

An SDT ceases to qualify where the trust deed fails to comply with the statutory requirements (s 1209P SSA91) or at the date of the death of the principal beneficiary (s 1209ZD SSA91).

If an immediate family member or principal beneficiary (or the principal beneficiary's partner) transferred an asset to the trust within the five-year period preceding the cessation of the trust, the transfer is deemed a disposal of an asset occurring at the time of the transfer (s 1209ZD(1) SSA91). The amount of the disposal is determined in accordance with a formula.

Taxation treatment of an SDT

Overview

The amendments do not alter the income tax treatment of the transfer of assets and the taxation of beneficiaries of the SDT.

A donor will usually transfer shares, units in trusts and real estate held on capital account to the SDT to provide income or accommodation for the principal beneficiary. The donor will need to consider and manage any CGT liability arising on the transfer of a CGT asset.

Revocable trust rules

Where a person creates a trust and income under that trust is payable to, accumulated for, or applicable for the benefit of that person's child who is under the age of 18 years, the Commissioner may assess the trustee to pay income tax, and the beneficiary is not assessed to pay income tax (s 102 ITAA36).

Where the donor establishing the SDT is a parent of the minor principal beneficiary, the Commissioner may potentially apply the provision during the principal beneficiary's minority. However, where an unrelated settlor established the SDT with a nominal settlement and the parents subsequently donate property, this provision will not apply (*Truesdale v FCT* (1971) 120 CLR 353). However, how the provision applies for a testamentary SDT where a parent is the testator is unclear.

Taxation of the principal beneficiary

Generally, social security disability support pensions are exempt from income tax (Subdiv 52-A ITAA97). A principal beneficiary who is over the age of 16 years, has a specified level of physical, intellectual or psychiatric impairment, and who has a continuing inability to work is likely to receive a disability support pension (s 94(1) SSA91).

Income from an SDT is taxable under the ordinary trust rules (Pt III, Div 6A ITAA36). A beneficiary who is presently entitled to a share of the net income of the trust and is not under a legal disability is taxable on that income at individual tax rates (s 97 ITAA36). However, where a beneficiary is under a legal disability, the trustee must withhold and remit tax on that income as if a separate individual at individual tax rates (s 98 ITAA36; *Xebec Pty Ltd (in liq) v Enthe Pty Ltd* 87 ATC 4570). A beneficiary under a legal disability will not have to lodge a tax return, unless in receipt of other income (s 100 ITAA36; TD 92/159). Where no beneficiary is presently entitled to the trust income, the trustee may be assessed at the top marginal rate, unless the Commissioner exercises his discretion.

The undefined term "legal disability" refers to a person who is unable to give an immediate valid discharge to the trustee in respect of a distribution, such as a minor (a person under 18 years old; *Taylor v FCT* (1970) 119 CLR 444) or a person who is mentally incapable (TR 2004/D25, para 67).

The principal beneficiary may be a minor or mentally incapable, and therefore under a legal disability. However, other forms of physical disability and intellectual and psychiatric impairment may be insufficient to constitute a legal disability for income tax purposes. Income tax liability will require a case-by-case assessment.

A minor beneficiary who is a prescribed person is taxable at the top marginal rate on the beneficiary's share of the net trust income that is not, in relation to that beneficiary, excepted trust income (s 102AG ITAA36). A minor beneficiary is not a prescribed person if for, or at the end of, that income year:

- the minor beneficiary is entitled to a child disability allowance (now the carer allowance, but the child disability allowance continues to apply for applications before 1 July 1999) or a disability support pension under the SSA91;
- the Commissioner receives a medical certificate stating that the minor beneficiary is a disabled child or has a continuing inability to work within the meaning of the SSA91; or
- the Commissioner receives a medical certificate stating that the minor beneficiary is a person who, by reasons of a permanent disability, is unlikely to be able to engage in full-time occupation.

A principal beneficiary in receipt of a disability support pension will usually not be a prescribed person and will be taxed at individual adult tax rates. However, it is unclear whether the exclusion applies to carer allowances (formerly child disability allowance). The taxation exclusions do not correlate with the SDT definitions and entitlements in the SSA91, arising from various amendments to the SSA91. Accordingly, an SDT arising from living in a hostel may not satisfy the exemption, and the principal beneficiary may be taxable at the penalty rate.

Where there is doubt about whether the minor principal beneficiary is a precluded person, a will should establish the SDT, because any income arising from the trust property will likely be excepted trust income arising from property that devolved for the benefit of the beneficiary from the estate of a deceased person (s 102AG(2)(d) ITAA36). If excepted trust income, the income will not be taxable at the penalty rate.

Main residence exemption

A capital gain made on the disposal of an individual's dwelling, or ownership interest in a dwelling used as a main residence throughout the entire ownership period, is exempt from CGT. A pro rata exemption is provided in certain circumstances (s 118-110 ITAA97). Previously, where a trustee of a trust (other than a bare trust or a testamentary trust) owned the dwelling, the main residence exemption did not apply. However, the ITAA97 has now been amended to allow the trustee of an SDT to access the main residence exemption (see below regarding the *Tax Laws Amendment (2011 Measures No. 7) Act 2011*).

A trustee of a testamentary trust may disregard a capital gain on disposal of the dwelling where (s 118-195 ITAA97):

- the deceased acquired the ownership interest before 20 September 1985; or
- the deceased acquired the ownership interest on or after 20 September 1985 and the dwelling was the deceased's main residence just before death and was not used for producing assessable income; and
- the dwelling was, from the deceased's death until disposal by the trustee, the main residence of an individual who had a right to occupy the dwelling under the deceased's will.

If a will establishes the SDT and grants the principal beneficiary a right to occupy the dwelling, on the death of the principal beneficiary the trustee may dispose of the property and claim a full or part main residence exemption.

Consultation paper — Greater fairness and equity in the taxation of special disability trusts

The Assistant Treasurer on 4 August 2009 released a consultation paper entitled "Greater fairness and equity in the taxation of special disability trusts". There are two proposed reforms in the consultation paper, which have both now been enacted.

- The first reform proposed by the consultation paper related to the income tax liability in relation to income of an SDT. This reform measure has been introduced by the *Tax Laws Amendment (2010 Measures No. 3) Act 2010* (see below).
- The second reform proposed by the consultation paper related to the CGT main residence exemption. It was proposed that Subdiv 118-B ITAA97 be amended to allow the trustee of an SDT to disregard a capital gain or loss made in relation to a dwelling that is used by the beneficiary of an SDT as their main residence as if the beneficiary was able to own the dwelling directly. This reform measure has been introduced by the *Tax Laws Amendment (2011 Measures No. 7) Act 2011* (see below).

Tax Laws Amendment (2010 Measures No. 3) Act 2010

The *Tax Laws Amendment (2010 Measures No. 3) Act 2010*, which received royal assent on 29 June 2010, amended the provisions of both the ITAA36 and the ITAA97 in relation to income tax liability of an SDT. The new provisions allow all of the income of an SDT to be taxed at the marginal rate of the principal beneficiary of the SDT as opposed to the unexpended income of an SDT being taxed pursuant to s 99A ITAA36 at the highest marginal tax rate (plus the Medicare levy). To achieve this change, a new s 95AB has been inserted into the ITAA36. This amendment applies to assessments for the 2008/09 income year and later.

Tax Laws Amendment (2011 Measures No. 7) Act 2011

The *Tax Laws Amendment (2011 Measures No. 7) Act 2011*, received royal assent on 29 November 2011. It has made the following amendments in respect of SDTs:

- amended Subdiv 118-A ITAA97 to include a new s 118-85 which provides that a capital gain or capital loss made is disregarded if it is made from the transfer of a CGT asset for no consideration to an SDT or a trust that becomes an SDT as soon as practicable after the transfer of the CGT asset;
- amended s 128-15(4) ITAA97 to ensure that the trustee of an SDT (or a trust that becomes an SDT as soon as practicable after the asset passes to it) disregards any unrealised capital gain or capital loss when an asset passes to them from a deceased person's estate;
- amended Subdiv 118-B ITAA97 to allow the trustee of an SDT to disregard a capital gain or loss made in relation to a dwelling that is used by the beneficiary of an SDT as their main residence as if the beneficiary was able to own the dwelling directly; and

- amended Subdiv 118-B ITAA97 to ensure that, on the death of the principal beneficiary of an SDT, the disposal of the main residence by the trustee of the SDT (or the trustee of an implied trust) may be subject to the main residence exemption based on the use of the dwelling by the principal beneficiary.

Each of these amendments apply to CGT events that happened on or after 1 July 2006.

Use of the SDT in structuring

Parents and other relatives have an opportunity to establish an SDT to care and provide accommodation for a severely disabled relative that offers significant social security concessions for the donor and the disabled relative. Parents with severely disabled children who are not entitled to social security benefits due to the value of their assets may be able to transfer sufficient assets to an SDT to satisfy the means tests and qualify for entitlements.

However, structuring the SDT correctly so that it qualifies and so there are no adverse income tax consequences will require careful consideration.

For further information on the deductibility of interest, see ¶7-145.

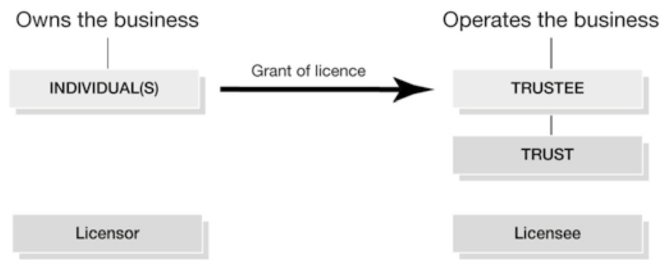
Chapter 4

Alternative use of trust structures

When using this part of the guide, it is recommended that, if you read a detailed guide, you also read the applicable key points guide as not all information provided in a key points guide will be covered in the detailed guide for a particular structure.
The detailed guides elaborate on the unique aspects of structures, while the key points guides address the common issues concerning structures.

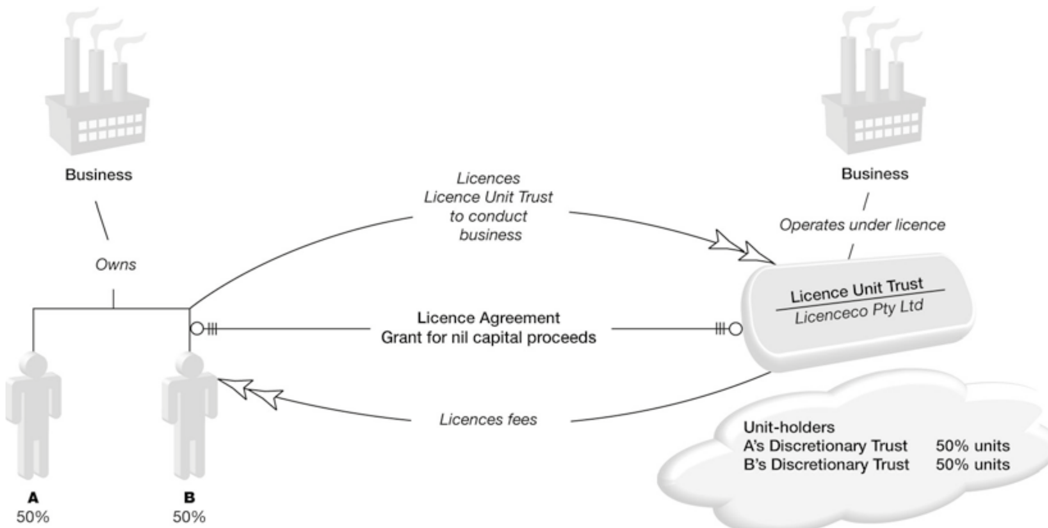
¶4-100 Licence agreement

Key points guide

Diagram	 Note: More comprehensive diagrams are provided in the detailed guide.	
Suggested application	■ To separate the operation of a business and its inherent risks from the ownership of the business. ■ To enable income from the operation of the business to be distributed to a range of beneficiaries. ■ Useful where a significant taxation liability would result if an existing business was restructured to achieve asset protection and/or income flexibility. With the licence arrangement, ownership is not transferred and, if the licence deed is properly drafted, no taxation liability will be incurred on the grant of the licence.	
Parties	Who is the legal owner of the assets and makes decisions on a daily basis?	The original owner (the licensor), but the licensee controls and makes decisions (through licence) as to the conduct of the business on a daily basis
	Who owns a beneficial interest in the assets?	The licensor
	Who establishes the structure?	The licensor who grants a licence
	Who appoints the legal owner?	Not applicable
Asset protection	■ To some extent, this structure achieves the same asset protection outcomes as the trust structure used by the licensee in the arrangement, as the licensor is not generally liable in respect of claims brought against the licensee in respect of the operation of the business. ■ The licensor may still retain liability in respect of claims relevant to the business itself. ■ Where the directors of the corporate trustee of the licensee entity are also the licensor, partners in the licensor or shareholders in the licensor, the link between the two parties (licensor and licensee) may defeat the asset protection objectives of the structure. Note: the availability of asset protection is based on the structure itself. Care should always be taken to review loans/entitlements that may exist between the various parties, including personal guarantees that may have been given.	

<table>
<tr><td rowspan="9">Key points guide</td><td>Income taxation</td><td colspan="3">The licensor will receive royalties under the licence and potential rental under leases for the provision of assets used in the business.
The licensee will derive profits from the operation of the business.
Note: income taxation consequences will depend on the structure of the entities. Refer to the key points guides in chapter 3 for a quick overview of the income taxation implications of the various structures.</td></tr>
<tr><td rowspan="5">Capital gains tax Concessions</td><td colspan="2">50% discount</td><td rowspan="5">Rights to goodwill in a business developed through operation can either:
■ revert to the licensor (the normal case); or
■ belong to the licensee.
So, on a disposal:
■ original goodwill is disposed by the licensor; and
■ developed goodwill is either disposed by the licensor or by the licensee.
Note: CGT consequences will depend on structure of the entities. Refer to the key points guides in chapter 3 for a quick overview of the CGT implications of various structures.</td></tr>
<tr><td rowspan="4">Small business concessions</td><td>50% active asset reduction</td></tr>
<tr><td>15-year exemption</td></tr>
<tr><td>Retirement exemption</td></tr>
<tr><td>Roll-over</td></tr>
<tr><td>Succession planning (estate planning)</td><td colspan="3">This will depend on the structure of the entities. Refer to the key points guides in chapter 3 for a quick overview of the succession planning implications of the various structures.</td></tr>
<tr><td>New investors</td><td colspan="3">Any issues to consider for the addition of new investors will arise as a result of the structure of the entities involved in the arrangement. Therefore, refer to the key points guides in chapter 3 for a quick overview of the new investor implications of various structures.</td></tr>
<tr><td>Other issues</td><td colspan="3">■ No stamp duty is payable in Victoria on the grant of the licence. Care needs to be taken in those jurisdictions where stamp duty is imposed on the transmission of a business, as the grant of the licence may constitute a dutiable transaction.
■ In a licence deed, it may be assumed that all developed goodwill will revert to the licensor unless specific instructions are otherwise provided.</td></tr>
</table>

Detailed guide — licence agreement



When would the structure be used?

A and B plan to operate a business in partnership. Each partner contributes equally to the business.

Over time, the partnership enjoys great success and A and B:

- acquire significant passive investment and personal assets such as family, holiday and investment homes and share portfolios;
- are concerned that those passive assets are exposed to claims by creditors either:
  - by virtue of the fact that the assets are in the partnership name; or
  - where the assets are held by a trust — they may be subject to being seized by creditors under the provisions of the *Bankruptcy Act 1966* for the recovery of assets
- consider that the asset protection and taxation benefits would outweigh the administrative, accounting and legal costs in changing the structure.

After making the decision above, A and B determine that if the partnership disposes of the business to a new trust structure (such as one outlined in chapter 3 of this guide) a significant taxation liability may be incurred.

A and B determine that, although transferring the business to a new trust structure may enable them to achieve:

- asset protection through the distribution of business profit from the partnership to other entities and, ultimately, to corporate beneficiaries (ie companies which A and B individually control and which are not exposed to risk and pay tax at the corporate rate of 30%); and

- flexibility of income distribution through being able to distribute income to a wide range of beneficiaries. This strategy might enable the partners to ensure that taxpayers (such as themselves) who pay tax at the top marginal tax rate receive less of the profit of the business — the profit instead being distributed to less risk exposed, lower marginal rate taxpayers or non-exposed corporate beneficiaries who pay tax at the corporate tax rate of 30%,

the capital gains taxation implications would outweigh those benefits and A and B determine that they have no option but to continue to operate the business through the current structure.

If A and B, instead of transferring the business to a new trust structure, granted a non-exclusive licence from the existing business entity to a new trust structure to allow the new trust structure to conduct the business, A and B could achieve the objectives outlined above.

In that event, in the diagram illustrated above, Licenceco Pty Ltd (as trustee of the Licence Unit Trust) would derive all income from the operation of the business, meet all its expenses (including payment of the licence fees from that income) and then distribute the remaining income equally between A's discretionary trust and B's discretionary trust.

Operation

The licence deed provides for the grant of a licence from the existing business entity (the licensor) to a new trust structure (the licensee) to allow the licensee to conduct the business.

The manner in which the licence is granted and the arrangement implemented needs to be carefully considered so that the arrangement achieves its objectives. Even though the parties are related, they need to ensure the arrangement is at least entered into on an arm's length basis.

The following table summarises the main aspects of the implementation and operation of the licence agreement arrangement.

Implementation	Existing business	The licence relates to an existing business so that it can only be used where the licensor has an existing business to license or has just purchased a business.
	Consideration	No amount is payable for the grant of the licence but a licence fee is payable for the use of the business and its assets, as specified in the deed. The licence fee is accordingly an income receipt of the licensor and not capital. The licence fee should be calculated on a commercial basis, taking into account the profitability of the business. The licence fee can be paid annually or monthly or in whatever manner best suits the parties.
	Intellectual property	The licensor licenses to the licensee the right to use the goodwill, business name, business information and other assets, but not any intellectual property (as defined by s 995-1 ITAA97) of the licensor. Intellectual property is defined as the rights of an owner or licensee in respect of a patent, registered design or copyright. Granting or assigning an interest in an intellectual property may be subject to a balancing adjustment under the capital allowance regime. If it is desired to license any item of intellectual property, that will need to be done by further documentation.
	Term	The licence is for a period of 12 months and does not provide an option for a further term. At the end of the 12-month term the licence continues on a monthly basis until terminated by either party.
	Non-exclusive	The licence granted is non-exclusive, so as not to restrict the business activities of the licensor.
	Termination	The terms of the licence agreement provide that either party can terminate the agreement by one party giving the other 30 days notice. The licence terminates automatically on a successful legal claim being made against the licensee.
	Indemnity	The licensee will indemnify the licensor and keep the licensor indemnified, both during and after the term, against all liabilities (whatever they may include) but not limited to all claims, actions, damages, losses, costs (with professional legal fees calculated on a solicitor and own client basis), disbursements, expenses and interest which might at any time be incurred by the licensor as a result of, or in connection with, the licensee's conduct of the business or the operation of the business from the grant of the licence.
	Business name	A transfer of any business name should be registered with the relevant state authority.
	Employees	Separate documentation needs to be prepared to deal with any employees of the licensor to be engaged by the licensee and any necessary salary and leave adjustments and provisions. A strategy to inform employees of the termination of their employment and engagement by licensee should be formulated. This strategy should be in accordance with any applicable contract of employment and relevant legislation.

Implementation	Client agreements	The licensor should review current agreements with clients and the need to notify them or obtain their consent to a change to the structure, such that their contracts are validly assigned to the licensee. The clients may want the licensor to guarantee existing contracts being assigned until the next renewal, at which time they could be renewed in the licensee's name.
	Plant and equipment	A review of lease and equipment hire contracts should be conducted to determine the ability and appropriateness for the rights under those contracts to be assigned, sub-leased or sub-hired.
	Insurance	The licensor should identify current insurance arrangements and negotiate new arrangements as necessary.
	Tax registrations	Current registrations in respect of payroll tax, WorkCover, group tax, superannuation, ABN, TFN, GST and PAYG should be reviewed and new applications made, or current applications amended as necessary.
	Bank accounts	The licensee should open bank accounts and make financial arrangements with a bank.
	Utilities	The telephone, gas, electricity and other service provider accounts relevant to the operation of the business should be transferred/assigned to the licensee.

Capital gains tax

There are no capital proceeds payable for the grant of the licence, so the market value substitution rule in s 116-30(3) ITAA97 does not apply. This rule, if it did apply, would deem that the licensor had received capital proceeds equivalent to the market value of the licence to operate the business, even if the licensor had not received those proceeds. This could result in a significant taxation liability being incurred without sufficient funds being available to meet that liability.

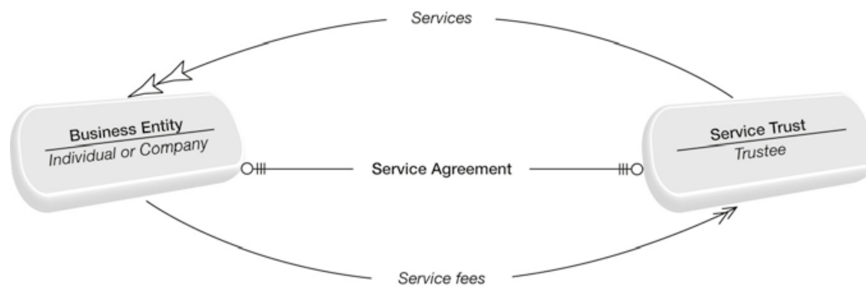
On a sale of the business by the licensor after termination of the licence, the licensor would self-assess its ability to access the various CGT concessions. The key points guides in this guide may assist in making that determination.

Warning

There are potential Div 7A ITAA36 and value shifting implications if the licensor business entity were a company and granted a licence for nil consideration.

Essentially s 109C ITAA36 states that a private company will be taken to pay a dividend to a shareholder or an associate of a shareholder in the private company if the private company makes a payment to that shareholder or associate. The definition of payment includes the transfer of property. For example, if A and B set up a company to operate a business and granted a licence for nil consideration to the Licence Unit Trust in which A and B were both unitholders, Div 7A would apply to deem the company to have paid a dividend equal to the market value of the licence granted. The effect of Div 7A may be mitigated if the annual licence fee was set at an arm's length market value.

¶4-105 Service agreement

<table>
<tr><td rowspan="8">Key points guide</td><td>Diagram</td><td colspan="2">

Note: More comprehensive diagrams are provided in the detailed guide.</td></tr>
<tr><td>Suggested application</td><td colspan="2">■ To protect the assets used in the business from the operation of the business by having business assets owned by a separate structure.
■ To enable profits from the service activities to be distributed to a range of beneficiaries.
■ To enable flexibility in planning for succession.
■ Where it is not possible to transfer the business to a new structure either because:
1. the regulations of the industry in which the business operates forbids such a restructure; or
2. the significant taxation liability that may arise from the restructure is unacceptable to the business.</td></tr>
<tr><td rowspan="4">Parties</td><td>Who is the legal owner of the assets and makes decisions on a daily basis?</td><td rowspan="4">There are two businesses — a trading business and a service provider business.
Therefore these issues need to be separately addressed for each structure.
Note: refer to the key points guides in chapter 3 for a quick overview of the various structures.</td></tr>
<tr><td>Who owns a beneficial interest in the assets?</td></tr>
<tr><td>Who establishes the structure?</td></tr>
<tr><td>Who appoints the legal owner?</td></tr>
<tr><td>Asset protection</td><td colspan="2">■ Assets in the service trust are protected from the risks to the business (eg claims by creditors).
■ Assets in the business (such as goodwill) are protected from the risks to the service provider (for example, unfair dismissal claims by employees).
■ Other asset protection issues relate to the structure of the entity itself. Refer to the key points guides in chapter 3 for a quick overview of various structures.
Note: the availability of asset protection is based on the structure itself. Care should always be taken to review loans/entitlements that may exist between the various parties, including personal guarantees that may have been given.</td></tr>
</table>

<table>
<tr><td rowspan="9">Key points guide</td><td>Income taxation</td><td colspan="3">Income taxation consequences will depend on structure of the entities. Refer to the key points guides in chapter 3 for a quick overview of various structures.</td></tr>
<tr><td rowspan="5">Capital gains tax concessions</td><td colspan="2">50% discount</td><td rowspan="5">Refer to the key points guides in chapter 3 for a quick overview of various structures. The ability to access taxation concessions will depend on the structures themselves, not necessarily the service arrangement.</td></tr>
<tr><td rowspan="4">Small business concessions</td><td>50% active asset reduction</td></tr>
<tr><td>15-year exemption</td></tr>
<tr><td>Retirement exemption</td></tr>
<tr><td>Roll-over</td></tr>
<tr><td>Succession planning (estate planning)</td><td colspan="3">■ Planning will depend on structure of the entities.
■ Refer to the key points guides in chapter 3 for a quick overview of various structures.
■ Properly structured, a service trust arrangement is a very effective tool in enabling a business to establish a succession plan, as it ensures that control of the business assets remains in the family.</td></tr>
<tr><td>New investors</td><td colspan="3">Any issues to consider for the addition of new investors will arise as a result of the structure of the entities involved in the arrangement. Therefore, refer to the key points guides in chapter 3 for a quick overview of various structures.</td></tr>
<tr><td>Other issues</td><td colspan="3">■ The arrangement must be carefully implemented and, once implemented, must be followed.
■ Details of the Commissioner's concerns with service trust arrangements are outlined in the detailed guide.</td></tr>
</table>

Detailed guide — the service agreement

Why a service agreement?

Not sure which structure to use? Use the chart at ¶2-110.

A service agreement is a useful structure for achieving several important objectives of business owners. It facilitates:

- the protection of the assets of the business from the risks of the business;
- the protection of the business from the liabilities relating to the service provider (particularly unfair dismissal claims that could be brought by employees);
- the flexibility of distribution of the income from the service provider's business; and
- the ability to implement greater flexibility in succession planning.

A service agreement is particularly useful where restructuring an existing business (from a sole proprietorship, partnership or corporate structure) through a trust structure is either:

- not permitted, due to the regulatory requirements of the industry in which the business operates; or
- would result in significant taxation and/or stamp duty liabilities.

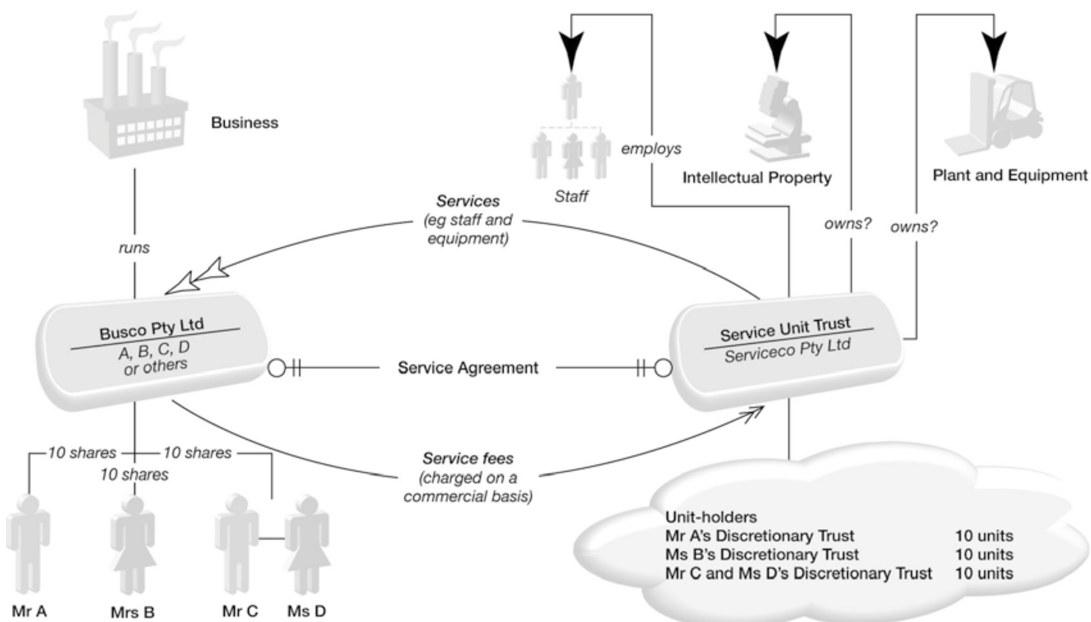
How does it work?

The following diagram illustrates the implementation of a service agreement.

The diagram illustrates the principal (Busco Pty Ltd) entering into a service agreement with a service provider (Serviceco Pty Ltd) for the provision of services required to enable the principal to conduct the business.

Particular aspects of the structure of the arrangement are discussed in further detail following.

It is important to ensure that a service agreement arrangement is not implemented by merely employing staff through a separate structure and charging the staff back to the principal at a mark-up. Proper documentation should be prepared, executed and followed. Further, the service provider should provide all the administrative and support services to the principal; this will involve the service provider owning all the plant and equipment of the business, and not on-charging those employees involved in the conduct of the service provider's business.



Asset protection

As noted above, protection of assets is achieved at two levels:

- first, the protection of the assets used in the business from the risks of the operation of the business; and
- second, the protection of the goodwill and operation of the business from the claims of employees of the business.

In industries with substantial numbers of administrative personnel and where there is a high level of risk from claims by those employees, two service agreement arrangements could be entered into — one with the employee entity and the other with the asset entity holding plant and equipment.

Flexibility in distribution of income

A service agreement arrangement, if properly implemented, will enable:

- the principal to claim an income tax deduction for the service fees paid to the service provider; and
- the income derived by the service provider to be distributed in accordance with the structure of that entity (typically a unit trust with discretionary trust unitholders — refer to the comments by the ATO outlined in the table in ¶4-105 of this guide).

The disadvantage with this structure (as compared with the similar structure that uses a licensing arrangement — refer to ¶4-100 of this guide) is the time involved in its proper administration and the limitation on the amount of income that can be derived by the service provider. The income is limited to commercial fees that may be charged for the services provided, rather than the income from the operation of the business.

Succession planning

The service agreement arrangement, where the service provider is a trust, provides significant advantages for succession planning.

It enables the owners of a business to separate the assets used in the business from the operation of that business, and put in place an ownership structure to ensure that the beneficial ownership of those business assets stays within the lineal descendants of the family.

It also enables flexibility in relation to the business dealings and the way in which participants in the business are brought into the ownership of the business and/or the assets used in the business.

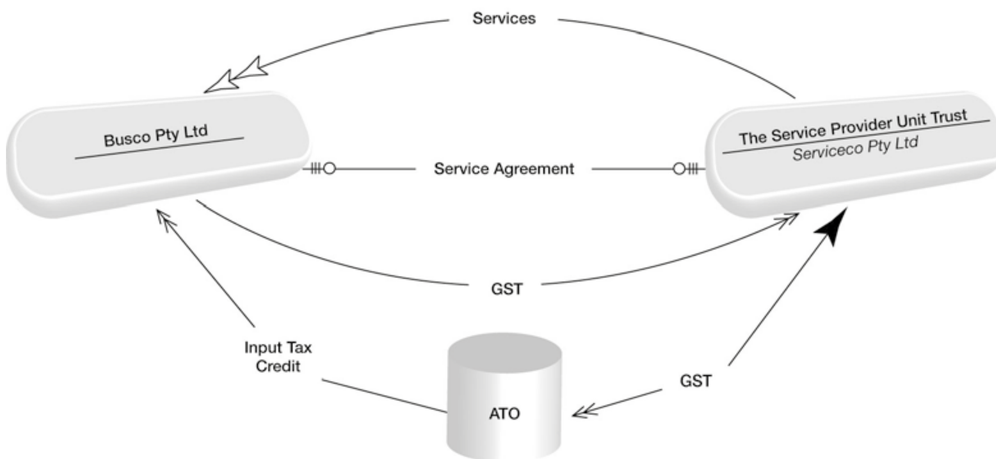
Goods and services tax

Consideration should be given to the GST consequences of the service agreement arrangement.

Both the principal and service provider should be registered for GST and be involved in enterprises making taxable supplies. In that event the services acquired by the principal should be creditable acquisitions, enabling the principal to claim back any GST on-charged by the service provider. An analysis of the GST consequences of the arrangement should be undertaken to ensure that this is the case.

The net effect of the GST should be tax neutral, save for any cashflow or timing impact on the payment of GST and recovery of input tax credits.

Care should be taken in relation to the grouping of entities for GST purposes (even if the structure of the entities would enable this to occur), as this could be indicative of a non-commercial arrangement.



The service agreement

A service agreement should ensure that:

- the arrangement is entered into on commercial arm's length terms such that the service fees and charges agreed to be paid are commercially realistic and the same or similar property or services would be provided by an independent person on the same (or substantially similar) terms;
- the arrangement is effective and systems are in place for its administration (for example, the inclusion of tax invoices). It is important that not only the form of the arrangement is considered but also its substance. Simply having an agreement is not sufficient. The principal must ensure that the arrangement is implemented and operated in accordance with the agreement; and
- payments made by the principal to the service provider for the services rendered are deductible under s 8-1 ITAA97, such that the expenses incurred have sufficient connection to the income-earning activities of the principal.

Phillips case

In the case of *Phillips v FCT* 78 ATC 4361 (*Phillips* case), the Federal Court ruled that payments made by an accounting partnership to a service company (which was the trustee of a unit trust) for the provision of non-professional services were wholly deductible under s 51(1) ITAA36. The service company had "hired" services to the partnership at a mark-up that was found by the Federal Court to represent a reasonable commercial rate for the provision of such services. The partners' relatives and family company/trusts to which the partners were associated held the units in the unit trust.

Thus, the crucial issue in the *Phillips* case was whether the payments to the service company were fully deductible, or whether they should have been apportioned on the basis there were purposes other than the gaining or derivation of assessable income which led to the payments being made. These other purposes, argued the Commissioner, were income diversion to relatives of the partners and the ability to inflate the size of the deductions for payments made to the service company.

Although the Federal Court unanimously held in the *Phillips* case that the payments by the partnership to the service trust were wholly deductible and were not to be apportioned, the court did sound a warning for taxpayers who might seek to exploit the service arrangements. Fisher J stated that:

> *A crucially important circumstance in the present matter is the unchallenged finding of the trial Judge that the charges paid by the firm were realistic and not in excess of commercial rates. The services were essential to the conduct of the firm's business and the fact that the charges paid were commercially realistic raised at least a presumption that they were a real and genuine cost of earning the firm's income … Doubtless the converse would apply, namely, if the expenditure was grossly excessive, it would raise the presumption that it was not wholly payable for the services and equipment provided, but was for some other purpose.*

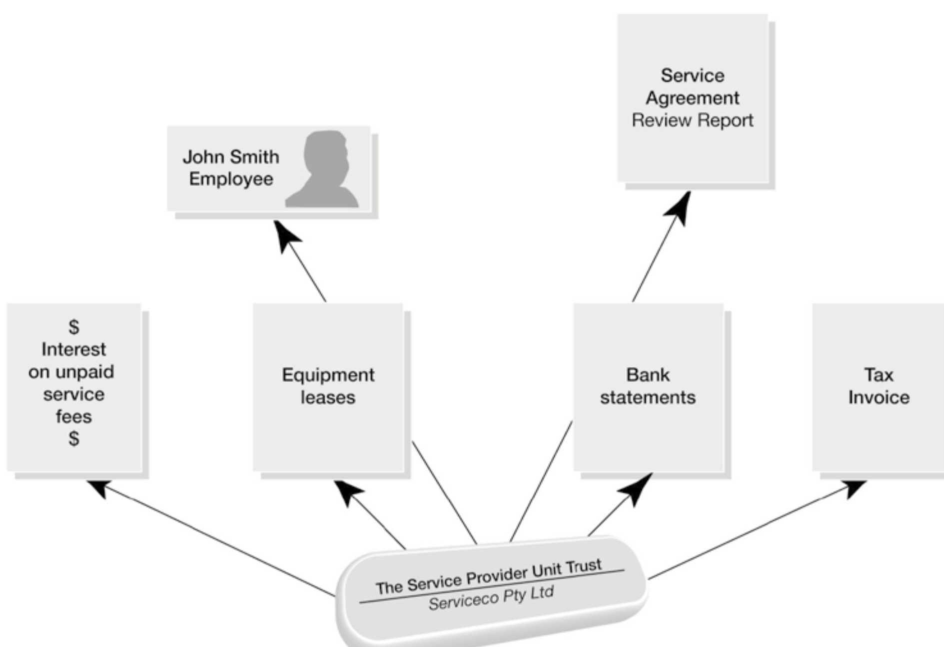
The Commissioner has accepted the validity of the principles enunciated by the Federal Court in the *Phillips* case (see IT 276, IT 2531 and TR 2006/2). In particular, the Commissioner accepts that service agreement arrangements are also entered into for asset protection purposes and reasons of administrative efficiency and simplicity. However, in each case the particulars of a service agreement, and especially the service charges paid to the service entity, may be scrutinised by the ATO — so it is imperative that the documentation in place is as specific as possible and that the method of calculation of service charges will not lead to charges being paid which are in excess of commercial rates.

Features of a service agreement

All of the features of a service agreement should seek to ensure that parties who are not in fact arm's length operate under an agreement and structure under which it would be expected parties who are acting at arm's length would operate.

The following table illustrates some of the features of a service agreement.

Features	Invoices	Invoices are to be raised monthly by the service provider to the principal. The invoices precisely set out the individual service fees payable for each month. A form of invoice should be included in the schedule to the agreement.
	Interest on unpaid fees	Interest is to be payable on unpaid amounts due from the principal to the service provider. The agreement should provide that a mortgage debenture over the assets and undertaking of the principal should be executed so as to provide security to the service provider.
	Bank account	The service provider must maintain a separate bank account into which service fees are paid.
	Employees	Employees are the responsibility of the service provider and all traditional employer responsibilities in relation to the employees are to be undertaken by the service provider.
	Equipment	Title to the equipment vests in the service provider, with appropriate covenants on the part of the principal in relation to the use of the equipment.
	Reviews	The agreement should provide for regular reviews of the service fees and the other terms of the service agreement, in a manner consistent with a commercial relationship between a professional service provider acting at arm's length with a principal.



Services provided by the service provider business

Services	Staff	The management, control and provision of staff necessary to suit the requirements of the principal. Responsibilities also include the employment and dismissal of staff.
	Equipment	The provision of equipment such as furniture, telephones, facsimile and photocopying machines as necessary to enable the principal to conduct the business.
	Debt collection	The collection of debts owed to the principal by its customers, and other amounts outstanding to the principal which, from time to time, the principal requires to be collected by the service provider.
	Financial statements	The preparation of all financial statements necessary for the external accountants of the principal to prepare the year end financial statements of the principal — including the maintenance of all records necessary to properly maintain the general ledger of the principal and prepare a trial balance of the principal on an ongoing basis.
	It services	The computer and administrative services required for the provision of the administration and operation of the business.
	Office supplies	All office supplies and materials to be used in connection with the conduct of the business.
	Finance and hire purchase	Negotiation of all financing, leasing and hire purchase contracts, including all the terms and conditions of those contracts.
	Premises	All services necessary for the proper management and administration of all properties, leased and/or occupied by the principal from time to time. The acquisition, design, layout, refurbishment and redecoration, sub-leasing, maintenance and repair of all those properties are included in the service.
	Other services	All other services not specifically identified above but necessary for the proper and efficient management and administration of the business. These additional services are provided from time to time by the service provider to the principal by agreement.

The Commissioner's scrutiny of service agreements

Through his IT 276 in 1978 and TR 2006/2 which was released on 20 April 2006, the Commissioner has indicated his acceptance of service agreement arrangements that comply with the arrangement described in the *Phillips* case.

The ATO has indicated through a variety of means its concerns over the inappropriate use and implementation of service agreement arrangements. The statements have ranged from comments in a case decision summary over the potential application of Pt IVA, to the 2000-01 annual report which indicated that service trust arrangements of accounting and legal partnerships would be reviewed. In that context, the ATO released TR 2006/2 and an explanatory booklet titled *Your service entity arrangements — NAT 13086* (the service arrangements booklet).

Initially, through its National Tax Liaison Group forum, the ATO indicated the issues it is particularly concerned with in respect of the operation and implementation of service agreement arrangements. The ATO released: a document that includes a list of factors in respect of which they are concerned; a letter to a principal entity paying service fees to a service provider; and a questionnaire. In a statement, the ATO stated:

> *The information requests are intended to test compliance with IT 276. In IT 276, the ATO indicated that we would accept service trust arrangements that were entered into for commercial reasons and with realistic charges that are not in excess of commercial rates paid to unrelated parties for the provision of similar services. This requires a close examination of all relevant facts. In each case, the deductibility of any service fees including application of Part IVA will depend on the particular facts.*
>
> *A table is attached which summarises some of the differences between the service arrangement in Phillips case and the arrangements more recently encountered by the ATO which taken together tip the scale beyond what seems to be explicable on commercial grounds. The differences are the result of the analysis of a number of factual circumstances and do not necessarily relate to any particular factual circumstance. Consequently, not all of these differences will necessarily exist in any one case. Nor will the absence of one or more of these differences necessarily mean that an arrangement is acceptable. Ultimately, the question for the Commissioner is whether a particular arrangement is "commercial".*

The table of factors identified by the ATO as being important is extracted below.

Phillips case	Variations
1. The *Phillips* case concerned a service arrangement between a partnership (Fell and Starkey) and a unit trust (the FMT). The Trustee and Manager of the FMT were both companies. The directors and shareholders of the Trustee and the Manager were not members of the partnership.	The service trust is a discretionary trust, the trustee of which is a company owned and controlled by the partners.
2. Income distributions from the FMT were fixed by the unitholdings.	The trust is discretionary in form. However, in substance the trust distributions are fixed by reference to the profit-sharing arrangements in the partnership. In effect, this means that the partners have the ability to direct the distributions on an annual basis.
3. In *Phillips*, the service arrangement was entered into and conducted in an arm's length manner.	The service arrangements are not established and conducted on an arm's length basis; documentation is poor.
4. The service fees and charges in the *Phillips* case were found to be realistic and not in excess of commercial rates.	The fees for the services provided are not commercially realistic and the net mark-ups are well in excess of market rates for the provision of equivalent services. For example, in some instances the service trust is more profitable than comparable labour hire firms or indeed the partnership itself.

Phillips case	Variations
5. In return for the service fees, Fell and Starkey were relieved from most problems of staff and office management and all financial obligations in respect of wages, sick leave, annual leave, long-service leave etc.	The partners retain management responsibility for oversighting the staff and services provided by the trust. The partnership is not relieved of all of the employment risk associated with the staff; nor is it relieved of the economic costs typically associated with the employment of permanent staff.
6. The service trust employed its own executive staff who were responsible for its operations, administration, staff supervision etc. It rented premises, held assets, bore a range of staff-related expenses and stood ready to sell its services direct to the business community.	The service trust does not rent or own premises or equipment; it has minimal assets; it does not solicit third party clients. It is difficult to identify any service trust staff who are not on-hired to the partnership and who are responsible for the operation and administration of the trust.
7. In *Phillips*, only the administrative and clerical staff were outsourced to the FMT.	All the permanent staff, including the professional staff, is hired via the service trust at substantial net mark-ups.

These earlier statements were formalised in TR 2006/2 and the service arrangements booklet. In particular in TR 2006/2, the Commissioner states that, although he accepts the correctness of the decision in *Phillips,* there are two bases on which he may audit service arrangements and disallow deductions.

(1) the first is that, on a "broader examination" (paras 10 and 11) of the service arrangement, the Commissioner may determine that the expenditure under the arrangement was "incurred in the connection with the pursuit of an advantage independent of the [principal's] income earning activities or business" (para 12) and based on a "fair and reasonable apportionment, the expenditure will not be deductible" under s 8-1 ITAA97 (para 14); and

(2) the second basis is under Pt IVA ITAA36 and states the issues to be considered when determining whether the dominant purpose of the service arrangement is to enable the principal to obtain a tax benefit.

In April 2006, the ATO announced that they would allow a period of 12 months for taxpayers to review their service arrangements with the benefit of the guidance provided in their service arrangements booklet. This period expired on 30 April 2007. Chapter 4 of the service arrangements booklet indicates that if the indicative rates set out in the chapter are followed and the service fees received by the service entity do not exceed 30% of the combined profits of the principal and the service entity, it is unlikely that an audit will be conducted by the ATO.

The service arrangements booklet states that there should be identifiable commercial benefits which enhance, assist or improve the principal's ability to produce income or make profits. To reduce the risk of audit by the ATO, proper documentation should be prepared, executed and followed, and should support the way in which the taxpayer has characterised and priced the benefits of the service agreement arrangement. Supporting documentation may include calculations of how service fees are calculated from time to time, as well as details of how mark-ups have been applied.

The service arrangements booklet gives some practical guidance on a couple of different approaches which may be taken to determine whether the services fees and charges are commercially realistic, being a comparable market prices and a comparable profits approach, with the latter including a cost plus approach and net profit approach.

In examining the issues above, it is clear that a majority of the issues of concern to the ATO relate to the actual implementation and operation of the arrangements. It is therefore important to ensure that implementation and operation are carefully managed.

Two other factors which should be noted are the ATO's concerns regarding the commerciality of the arrangements and fees charged, and whether there is appropriate documentation in place.

In respect of the commerciality of the arrangement, commercially realistic rates are not of itself conclusive that all or part of the fees are deductible. However, the greater the divergence is, the greater the likelihood becomes of a conclusion that other benefits are being sought. Note the comments made in ¶4-100 of this guide. Further, the manner in which the actual fees are set is also very important. One possible method by which the fees are calculated in the service agreement is outlined in the following table.

Calculation of service fees in a service agreement

Calculation	Staff	The formula included in the agreement should ensure that the mark-up applied to the cost of the provision of each staff member only applies to the actual hours that the staff member is engaged in providing services to the principal. The hourly rate should be calculated with reference to the total aggregate salary, superannuation contributions, fringe benefits and fringe benefits tax payable in respect of each staff member. The formula must ensure that the service provider and not the principal will be liable for all PAYG tax instalments, payroll tax, WorkCover premiums and other on-costs associated with employment of staff members and also all public holiday, annual leave, sick leave and long-service leave entitlements.
	Equipment	This charge is a daily rate referenced to the actual daily cost to the service provider in providing the equipment.
	Other services	The agreement allows the service fees for the provision of services other than those referred to above to be calculated by a mark-up to the actual cost to the service provider in providing services. The mark-up or percentage is to be agreed on between the principal and the service provider. As noted in the ATO's statements outlined above, it is important that the percentage mark-up approximates commercial rates for the provision of the type of service to be provided, so that no element of the deduction claimed by the principal for payment of these service charges can be apportioned or disallowed by the Commissioner. Although it is unlikely that agreement will not be forthcoming between the principal and the service provider as to the percentage mark-up, the clause could allow for a default position of a valuation by the President of the Institute of Chartered Accountants or the Australian Society of Certified Practising Accountants.

Calculation	Debt collection	In respect of the collection of debts owed to the principal, an amount equal to a percentage of fees collected is charged. However, the agreement provides that a charge for debt collection services will only be made where, first, the persons engaged in the debt collection are persons employed by the service provider and, second, the time those persons are engaged in debt collection is not otherwise charged by the company for the provision of that person to the company as one of the company's staff members.
	Unpaid fees	The percentage rate of interest to be charged on unpaid amounts for service fees owing to the service provider should be outlined in the schedule to the agreement. This percentage should be similar to the percentage that financial institutions charge for business loans.

Whether such a methodology is acceptable to the ATO is not known. The service arrangements booklet outlines some indicative fees which the ATO accepts are commercially realistic, where the services have a reasonable commercial connection to the principal's business.

	Arrangement	Characteristics	Fees & charges

Acceptable fees	Labour hire — temporary staff	■ the service entity employs staff on a casual basis or on short-term employment contracts, where
		  ■ a casual employee is a person not entitled to holiday pay or sick leave, and
		  ■ a short-term employment contract is an employment contract the duration of which is, or is reasonably expected by the employee, to be less than 12 months,
		■ the service entity on-hires the staff to you for a limited period under a hiring contract that sets out your respective rights and obligations regarding the staff,
		■ you pay a service charge which is calculated as a multiple of the hours worked and an hourly rate specified in the hiring contract, and
		■ the service entity maintains its own premises and equipment and employs its own managers and HR staff (who are not onhired to you) who are responsible for recruiting, employing, administering and on-hiring the temporary staff.
			The labour hire fees result in the service entity deriving a net mark-up of less than or equal to 5% on the direct and indirect (note 1) operating costs associated with its on-hiring of the temporary staff.

	Arrangement	Characteristics	Fees & charges
Acceptable fees	Labour hire — permanent staff	■ the service entity employs staff on a permanent basis or on long-term employment contracts, where ■ a permanent employee is a person who is entitled to holiday pay or sick leave, and ■ a long-term employment contract is an employment contract the duration of which is, or is reasonably expected by the employee to be, equal to or greater than 12 months, ■ the service entity on-hires the staff to you for a nominated period under a hiring contract that sets out your respective rights and obligations regarding the staff, ■ you pay a service charge which is calculated at a rate specified in the hiring contract, and ■ the service entity maintains its own premises and equipment and employs its own managers and HR staff (who are not onhired to you) who are responsible for recruiting, employing, administering and on-hiring the permanent staff.	The labour hire fees result in the service entity deriving a net mark-up of less than or equal to 3.5% on the direct and indirect (note 1) operating costs associated with its on-hiring of the temporary staff.
	Recruitment	■ the service entity undertakes staff search and recruitment activities on your behalf, ■ you pay the service entity a once-off success fee if you engage a candidate identified by the service entity, and ■ the service entity maintains its own premises and equipment and employs its own managers and recruitment staff who are responsible for undertaking the search and recruitment activities.	The recruitment fees result in the service entity deriving a net mark-up of less than or equal to 5% on the direct and indirect (note 1) operating costs associated with its recruitment activities.

	Arrangement	Characteristics	Fees & charges
Acceptable fees	Expense payments	■ the service entity provides bill administration and payment service, and ■ the service does not involve the provision of finance or other financial supply. Note: If finance is provided, the appropriate rate will have regard to individual factors including the cost of finance, and source of funds for the service entity and the terms of credit offered to you.	a mark-up not exceeding 5% on direct and indirect (note 1) operating costs associated with its expense payment activities.
	Equipment hire	■ the service entity owns the equipment, and ■ the service entity leases the equipment to you on ordinary commercial terms.	The hiring fee results in the service entity deriving a return on assets of less than or equal to 9% of the written down value of assets used in the hiring activity (note 2).
	Rental	■ the service entity owns or leases the property, ■ the service entity leases or subleases the property to you on ordinary commercial terms, and ■ you do not provide any guarantees or undertakings for the service entity's borrowing obligations in relation to the property (if any) or for its obligations under the head lease.	The rent is at market rates (plus finder fees where appropriate).

1. Indirect operating costs should be apportioned on a reasonable basis. For example, if the service entity provides both temporary and permanent labour hire services, then its indirect operating costs should be allocated between the temporary and permanent hire functions in the same proportion as the temporary and permanent on-hired staff bear to each other.
2. The actual hiring fee charged by the service entity would generally include depreciation, direct and indirect costs and this return on assets component.

The service arrangements booklet considers medical practice arrangements specifically at chapter 5. The comments made in relation to medical practice arrangements appear to isolate medical practice arrangements from the ordinary methodology used when determining service fees payable, by stating that their "examination of independent practice management arrangement shows that service fees of up to 40% of gross practice fees are likely to be appropriate regardless of the context and circumstances of a particular arrangement". Before relying on this statement of the ATO it is necessary to determine that the proposed arrangement is comparable to that considered by the ATO. It should also be remembered that the service arrangements booklet is not binding on the ATO, although it is indicative of the ATO's position.

The Commissioner's guidelines on the allocation of profits within professional firms

The ATO has released guidelines on how it will assess the risk of Pt IVA ITAA36 applying to the allocation of profits from professional firms carried on through trusts, as well as partnerships and companies, where the income of the firm is not personal services income.[1]

The guidelines apply to:

- individual professional practitioners (IPPs) that provide professional services; and
- firms that operate via a legally effective partnership, trust or company, and where the income of the firm is not personal services income.

The ATO is concerned about tax compliance risks associated with the allocation of practice profits that are treated as being derived from a business structure, even though the source of that income remains, to a significant extent, the provision of professional services by one or more individuals. The ATO considers that Pt IVA has potential application where the IPP arranges for the distribution of business profits or income to associates without regard to the value of the services that the IPP has provided to the business, particularly where:

- the level of income received by the IPP does not reflect their contribution to the business and is not otherwise explicable by the commercial circumstances of the business;
- tax paid by the IPP and/or associated entities on profits of the practice entity is less than that which would have been paid if the amounts were assessed in the hands of the IPP directly;
- the IPP is, in substance, being remunerated through arrangements with their associates; and
- the structure does not provide the IPP with advantages, such as limited liability or asset protection.

The ATO indicates that taxpayers will be rated as low risk and will not be subject to compliance action where they meet one of the following benchmarks in relation to their income from the firm:

(1) the IPP needs to receive remuneration that is equivalent to, or higher than, the lowest paid member of the upper quartile of the highest band of professional employees providing equivalent services to the firm;

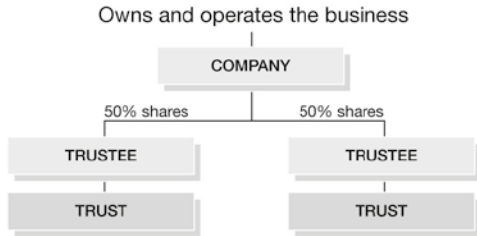
(2) 50% or more of the income from the firm to which the IPP and their associated entities are collectively entitled (whether directly or indirectly through interposed entities) in the relevant year must be assessable in the hands of the IPP; or

(3) the effective tax rate must be 30% or higher on both income from the firm to which the IPP is entitled and income from the firm to which the IPP and their associated entities are collectively entitled.

1 Available at www.ato.gov.au/business/starting-your-own-business/in-detail/professional-firms/Assessing-the-risk--allocation-of-profits-within-professional-firms.

¶4-110 Corporate structure

Key points guide

Diagram	 Note: More comprehensive diagrams are provided in the detailed guide.	
Suggested application	■ Where the business must be operated through a corporate structure because of regulatory requirements. ■ Where it is desired to have a structure where profits may be accumulated and asset protection risks in having those funds retained in the business are determined to be acceptable. ■ To enable income from the operation of the business to be distributed to a range of beneficiaries.	
Parties	Who is the legal owner of the assets and makes decisions on a daily basis?	The company
	Who owns a beneficial interest in the assets?	The company (trusts own shares in the company but not the assets of the company)
	Who establishes the structure?	Shareholders and directors incorporating the company
	Who appoints the legal owner?	The directors in meeting, subject to the shareholders in general meeting
Asset protection	■ Retained earnings in the company will be subject to the trading risks of the company. ■ Shareholders will have no exposure to the risks of the business of the company, beyond the fully paid subscription for shares. ■ The company is protected from claims by creditors of those who hold interest in the structure (shareholders) — although a shareholder's interest in the structure may be seized by their creditors. Note: the availability of asset protection is based on the structure itself. Care should always be taken to review loans/entitlements that may exist between the various parties, including personal guarantees that may have been given.	

<table>
<tr><td rowspan="14">Key points guide</td><td>Income taxation</td><td colspan="3">■ Income derived by the company will be taxed at the corporate tax rate (30%).
■ There is *NO* flow-through taxation, so that income distributed by the company will be distributed as dividends and subject to the dividend imputation rules (a general discussion of which is beyond the scope of this guide).
■ Distribution of income to shareholders must be in accordance with a shareholder’s right to income.</td></tr>
<tr><td rowspan="5">Capital gains tax concessions to the structure</td><td colspan="2">50% discount</td><td>✗ Not available</td></tr>
<tr><td rowspan="4">Small business concessions</td><td>50% active asset reduction</td><td>✓ Available (but can only be distributed as an unfranked dividend).</td></tr>
<tr><td>15-year exemption</td><td>✓ Available (if there is a significant individual[1] throughout a total of 15 years)</td></tr>
<tr><td>Retirement exemption</td><td>✓ Available (if there is a significant individual[1] in year of disposal)</td></tr>
<tr><td>Roll-over</td><td>✓ Available</td></tr>
<tr><td></td><td colspan="2">50% discount</td><td>✓ Available</td></tr>
<tr><td rowspan="5">Capital gains tax concessions to share- holders</td><td rowspan="5">Small business concessions</td><td>50% active asset reduction</td><td>✓ Available</td></tr>
<tr><td>15-year exemption</td><td>✓ Available (note the test period)</td></tr>
<tr><td>Retirement exemption</td><td>✓ Available</td></tr>
<tr><td>Roll-over</td><td>✓ Available</td></tr>
<tr><td colspan="2">Note: small business CGT concessions are only available to a shareholder that is:
1. an individual who is a CGT concession stakeholder[2] in the company; or
2. an entity in which CGT concession stakeholders[2] of the company have an aggregate small business participation percentage[3] of 90%.</td></tr>
<tr><td></td><td colspan="3">Note: the availability of CGT concessions only relates to the availability to the structure. Consideration must be given to the requirements for accessing the concessions outlined in the ITAA97, and the requirement to distribute amounts of net capital gains in some circumstances to avoid the benefit of the concession being eroded by the gross-up rules in Subdiv 115-C ITAA97.</td></tr>
<tr><td>Succession planning</td><td colspan="3">■ The assets of the company are not owned by any one shareholder and do not form part of an individual shareholder’s estate on their death — although shares held by an individual would form part of that estate.
■ Ultimate control of the company resides with the shareholders who, by resolution at a meeting, may remove and appoint directors.</td></tr>
</table>

Key points guide	New investors	■ May apply for new shares in the company for which they will contribute funds that the company will use for its activities. ■ May purchase shares from existing shareholders.
	Other issues	■ It is possible that a corporate trustee holding greater than 50% of the shares in the company may be responsible for the debts of the company, should it trade while insolvent pursuant to s 588V of the *Corporations Act 2001*. ■ The legislative requirements of the *Corporations Act 2001* need to be considered in any activities of the company (eg share buybacks have strict timing requirements for disclosures and documents to be prepared and lodged, as opposed to redemptions of units in a unit trust structure which are not subject to such regulatory procedures). ■ Interest on borrowings to acquire shares may be deductible. ■ Where trusts hold the shares in the company, the ability to pass franking credits to the beneficiaries of those trusts should be considered — particularly where the franking credits received by a beneficiary from all sources would exceed $5,000.[4]

1 A "significant individual" is an individual who has a small business participation percentage[3] in the trust of at least 20%.

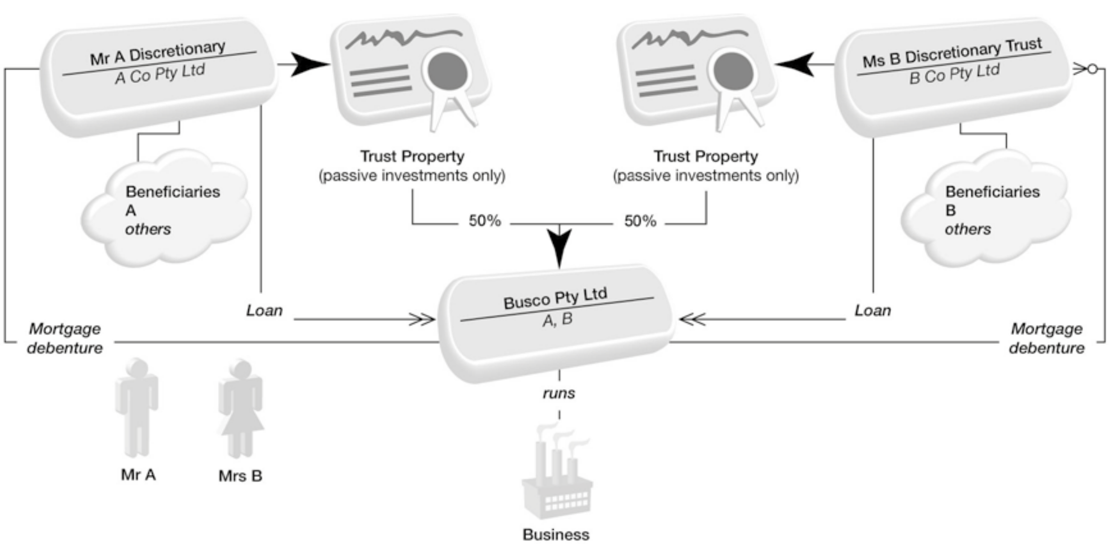
2 A "CGT concession stakeholder" is a significant individual[1] of the trust or a spouse of the significant individual.[1]

3 The meaning of "small business participation percentage" is outlined in ¶3-110 of this guide.

4 Refer to the discussion of the ability of beneficiaries of trusts to access franking credits in ¶7-110 of this guide.

Detailed guide — corporate structure

Structure diagram



The above diagram illustrates the structure.

In the above variant to the corporate structure, the trading company's operating capital has been sourced from loans made by discretionary trusts (who hold a nominal number of shares) protected by mortgage debentures the company has granted over its assets.

Alternatively, the trusts could subscribe the amount of the loans for shares. However, the amount subscribed would then be subject to the risks of the business, with little prospect of being recovered if the company became insolvent.

The loan arrangement provides better security as the trust shareholders (with the benefit of the mortgage debentures) would rank above any unsecured creditors (note below).

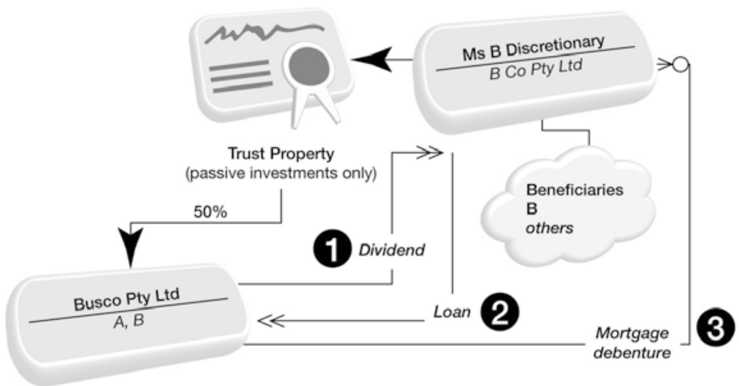
Of course, other issues should be considered with that proposal, such as:

- whether only a nominal number of shares should be held relevant to considerations for new investors investing at market value — that is, the existing shareholders could be outvoted by new equity participants if the new interests were fully capitalised and the existing interests were merely debt rather than equity;
- whether discretionary trust shareholders could only access both the 50% CGT discount and the small business CGT concessions on a disposal of their shares. The small business CGT concessions are only available for discretionary trust shareholders where CGT concession stakeholders in the company have between themselves a small business participation percentage in the discretionary trust shareholder of 90%. The meaning of CGT concession stakeholder and small business participation percentage is discussed in ¶3-110 of this guide; and
- the regulatory requirements of the industry in which it is proposed to conduct the business, and the rules that the relevant industry body may impose in relation to shareholding and directorship in a corporate entity.

Distribution and re-investment of profits

Assume Busco Pty Ltd makes a profit and (1) distributes a dividend to its shareholders (in the example that follows, we look at the Ms B Discretionary Trust). The Ms B Discretionary Trust then (2) lends this money to Busco Pty Ltd, which is (3) secured by a mortgage debenture given by Busco Pty Ltd. This is similar to the arrangement described above in ¶4-105 of this guide.

In this way, if Busco Pty Ltd were placed in liquidation, the amount of the outstanding debt owed to the Ms B Discretionary Trust would be paid in priority to unsecured creditors.



The Mr A Discretionary Trust and the Ms B Discretionary Trust could invest dividends received and not re-lent to Busco Pty Ltd to acquire passive investments and those passive investments would not be exposed to the risks of the business conducted by Busco Pty Ltd directly (save for any guarantees that may have been given to any financial institutions or leasing companies).

If the passive investments were instead held by the directors of Busco Pty Ltd, this potential protection may be lost. In this event, the assets would be exposed to the risks of the business through the directors' exposure to liability for insolvent trading and other claims that could be brought against the company and for which the directors may be responsible (these liabilities may include such things as the company's PAYG liabilities).

Income taxation

Any dividends received by the Mr A Discretionary Trust and the Ms B Discretionary Trust would not be subject to any further tax if the amount of the dividends were distributed to a company.

However, as with all corporate structures, care should be taken in paying the amount to individuals who might have a further tax liability after the amount is grossed up by the franking credits and after tax is paid at the taxpayer's marginal rate.

The ability to pass through franking credits to the beneficiaries of trusts should be considered — particularly where the franking credits received by a beneficiary from all sources would exceed $5,000. Refer to the discussion of the ability of beneficiaries of trusts to access franking credits in ¶7-110 of this guide.

If, instead of declaring a dividend, the company paid out profits by way of a loan, Div 7A ITAA36 might apply. If that division applied, the amount of the loan would be treated as an unfranked dividend and would be subject to tax at the taxpayer's marginal tax rate. As this amount was sourced from taxed profits made by the company, the deeming of an unfranked dividend would have the effect of taxing the same income twice.

Chapter 5

The standard private company as corporate trustee

¶5-100 Liability of directors of corporate trustees

Many trust structures use corporate trustees to ensure that the trustee of the trust has limited liability in respect of its activities as trustee. The use of a corporate trustee rather than an individual as trustee better protects the individual's assets from claims by creditors of the trust structure. Even when an individual acts as the director of the company and is exposed to some personal liability (such as personal liability in the event of insolvent trading), this exposure to risk is much less than the individual would otherwise face if the individual was to act as the trustee of the trust.

The *Corporations Amendment Act (No. 1) 2005*, effective from 18 November 2005, amended the wording of s 197(1) of the *Corporations Act 2001* (the Act) and in doing so clarified the scope of personal liability of directors of corporate trustees.

The new s 197(1) states:

> *A person who is a director of a corporation when it incurs a liability while acting, or purporting to act, as trustee, is liable to discharge the whole or a part of the liability if the corporation:*
>
> *(a) has not discharged, and cannot discharge, the liability or that part of it; and*
>
> *(b) is not entitled to be fully indemnified against the liability out of trust assets solely because of one or more of the following:*
>
> *(i) a breach of trust by the corporation;*
>
> *(ii) the corporation's acting outside the scope of its powers as trustee;*
>
> *(iii) a term of the trust denying, or limiting, the corporation's right to be indemnified against the liability.*
>
> *The person is liable both individually and jointly with the corporation and anyone else who is liable under this subsection.*
>
> *Note: The person will not be liable under this subsection merely because there are insufficient trust assets out of which the corporation can be indemnified.*

The Act provides that a director of a corporate trustee will be held personally liable to the debts of the corporate trustee in instances where: the company has not and cannot discharge the incurred liability; the company is not entitled to be indemnified because of any disentitling conduct, such as acting in breach of trust; or simply the trust deed denies or limits the right to indemnity against the liability. Importantly, directors will not be held personally liable merely because the trust does not have sufficient assets to satisfy the debt.

The amendments address the criticism of the decision in *Kerry Stirling Hanel v John O'Neill* [2003] SASC 409 (*Hanel v O'Neill*).

Hanel v O'Neill

The court held by majority decision that directors of a corporate trustee may be personally liable for the company's debts if the trust fund had insufficient assets to meet the debts, regardless of whether the trustee was entitled to be fully indemnified out of the trust's assets.

When reaching its decision, the court considered the operation of former s 197(1) of the Act. In essence, the former s 197 imposed personal liability on directors of a corporate trustee for debts incurred by that company. The court held that the director of a corporate trustee was personally liable for debts incurred by the company if the trust did not hold sufficient assets to meet the debt.

Facts

Daroko Pty Ltd (Daroko) as trustee of the Daroko Unit Trust (the trust) conducted a business on the premises of John O'Neill (O'Neill) under a lease. Kerry Hanel (Hanel) was the sole director of Daroko.

On 30 June 2001, the profits from the business conducted by Daroko on behalf of the trust ($512,617) were distributed by Daroko to Forcett Pty Ltd as trustee of the Kerry Hanel Investments Trust. On 22 August 2001, Daroko paid $1,000 to O'Neill in what it stated was the final payment under the lease. The lease had actually not expired and Daroko could not unilaterally bring the lease to an end.

O'Neill brought an action against Daroko claiming $23,135.62 for the costs associated with obtaining a replacement tenant for the property which Daroko had leased. Daroko had no assets to satisfy the claim and as the assets of the trust (being its profit from trading in the year ended 30 June 2001) had been distributed to the Kerry Hanel Investments Trust, there were insufficient assets in the trust to satisfy a claim by Daroko under its right to be indemnified from the trust's assets.

As the trust's funds were insufficient to satisfy O'Neill's claim, O'Neill brought action against Mr Hanel personally under s 197 of the Act.

Former s 197 of the Corporations Act 2001

The former s 197 provided that directors of corporate trustees were personally liable for the debts incurred by the trustee where there was no entitlement to be fully indemnified from the trust's assets. Subsection (1) previously stated as follows:

> *(1) A person who is a director of a corporation when it incurs a liability while acting, or purporting to act, as trustee, is liable to discharge the whole or a part of the liability if the corporation:*
>
> *(a) has not, and cannot, discharge the liability or that part of it; and*
>
> *(b) is not entitled to be fully indemnified against the liability out of trust assets.*

This is so even if the trust does not have enough assets to indemnify the trustee. The person is liable both individually and jointly with the corporation and anyone else who is liable under this subsection.

The decision

The Supreme Court decided in a two to one majority in favour of O'Neill.

In *Hanel v O'Neill,* the court held that where the assets of a trust are insufficient to satisfy the debt, "there is no entitlement to be fully indemnified". The decision in *Hanel v O'Neill* involved the examination of the former s 233, the statutory predecessor of s 197. Section 197(1) provided "This is so even if the trust does not have enough assets to indemnity the trustee", while the former s 233 stated that a trustee was not to be taken as "not entitled to full indemnity" due to insolvency of the trust. Given that the section was re-enacted using different words, the court considered that the legislature's intent was not to extend protection to directors.

Mullighan J stated: "I accept the argument … that if there are no assets comprising the Trust Fund, there is no entitlement to be indemnified." Further, Gray J said: "The construction contended for by counsel for Mr O'Neill would ensure that the director of a corporate trustee had a personal liability in circumstances where a debt was incurred and there were insufficient trust assets to meet the debt. Such a result is not unfair nor unreasonable. Section 197 represents an extension to the liability of the director of a trustee company."

In contrast, Debelle J confirmed the traditional view. In dissent, Debelle J held that the "director will not be liable merely because the assets of the trust are insufficient to indemnify the corporation for the relevant liability". Debelle J was satisfied that a legal indemnity exists in favour of the corporate trustee, regardless of whether the assets in the trust are sufficient to discharge the debts.

The current position

The amendment to s 197(1) outlined above addresses the problems created by the majority decision of *Hanel v O'Neill*. However, as the amendment came into effect on 18 November 2005, any liability incurred prior to that date may still be subject to the interpretation of the former s 197.

Chapter 6

The difference between distributable and taxable income

¶6-100 Introduction

The structure of Div 6 is to tax a beneficiary that is presently entitled to the taxable income of a trust (ss 97 and 98 ITAA36). Should a beneficiary not be presently entitled to part or all of the income, the trustee is taxed on that income (s 99 or 99A ITAA36).

Division 6 relevantly states:

> *97 Beneficiary not under any legal disability*
>
> *(1) … where a beneficiary of a trust estate … is presently entitled to a share of the income of the trust estate:*
>
> *(a) the assessable income of the beneficiary shall include:*
>
> *(i) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident; and*
>
> *(ii) …*
>
> *(b) the exempt income of the beneficiary shall include:*
>
> *(i) so much of the individual interest of the beneficiary in the exempt income of the trust estate as is attributable to a period when the beneficiary was a resident; and*
>
> *(ii) …*
>
> *except to the extent to which the exempt income to which that individual interest relates was taken into account in calculating the net income of the trust estate.*
>
> *95 Interpretation*
>
> …
>
> ***"net income"**, in relation to a trust estate, means the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions, except deductions under Schedule 2G and except also, in respect of any beneficiary who has no beneficial interest in the corpus of the trust estate, or in respect of any life tenant, the deductions allowable under Division 36 of the Income Tax Assessment Act 1997 in respect of such of the tax losses of previous years as are required to be met out of corpus.*

In 1978 and 1979, Grbich, Munn and Reicher and Mark Leibler published their views regarding the taxation of trusts which addressed whether:[1]

- the "proportionate approach" or "quantum approach" applied to allocating the net income of a trust to beneficiaries; and
- the term "income of the trust estate" referred to "trust accounting income" or "trust income" for the purposes of ss 97 and 98 ITAA36.

1 Y Grbich, G Munn and H Reicher, *Modern trusts and taxation*, Commercial Law in Context Series, 1978; and M Leibler, "Distributions of trust income — some selected problems", *Tax essays*, vol 1, Sydney, Butterworths, 1979.

Despite these issues being known to practitioners and the ATO for over 30 years, clear judicial authority on these issues has only recently been provided by the High Court. Further, a number of related issues remain unresolved and administrative guidance in this area is still developing.

This chapter considers both the historical analyses and the current position under the recently enacted interim measures described in more detail in ¶6-160 of this guide.

¶6-105 The Bamford decision: "income of the trust estate"

The High Court's recent decision in *FCT v Bamford* [2010] HCA 10 finally provided authority on the two questions of law described above.

First, the High Court confirmed that the "income of the trust estate" to which a beneficiary is presently entitled for the purposes of s 97(1) ITAA36 is determined in accordance with trust law principles. As explained in further detail in this chapter, this means that the provisions of the trust's deed are relevant to determining the income of the trust estate and that this is not restricted to ordinary or tax law concepts of income.

Prior to the *Bamford* litigation, there was considerable uncertainty as to what was meant by "income of the trust estate".

Notes

Prior to the *Bamford* litigation, there were broadly three different interpretations of "income" or "income of a trust estate" in s 97(1) ITAA36, namely:

- ordinary income (being only income according to ordinary concepts);
- assessable income (being income according to ordinary concepts and other amounts deemed income by revenue law); or
- trust law income (being ordinary income and other amounts deemed income by trust law).

However, *Bamford* provides authority that the third meaning above is the correct interpretation. The joint judgment of the High Court stated that:

> 36. *The very juxtaposition within s 97(1) of the defined expression "net income of the trust estate" and the undefined expression "the income of the trust estate" suggests that the latter has a content found in the general law of trusts, upon which Div 6 then operates.*
>
> 37. *The opening words of s 97(1) speak of "a beneficiary of a trust estate" who is "presently entitled to a share of the income of the trust estate". The language of present entitlement is that of the general law of trusts, but adapted to the operation of the 1936 Act upon distinct years of income.*
>
> …
>
> 38. *The identification in s 97(1) of "a trust estate" of which there is "a beneficiary" also bespeaks the general law of trusts.*
>
> …
>
> 39. *Further, the phrase "presently entitled to a share of the income" directs attention to the processes in trust administration by which the share is identified and entitlement established.*

This decision of the High Court upheld the earlier 2009 decision of the Full Federal Court[2] and, in doing so, also confirmed similar judicial analysis provided in earlier cases such as *Cajkusic*,[3] *Zeta Force*[4] and *Richardson*.[5]

¶6-110 The Bamford decision: "that share"

The second principle confirmed by the High Court in *Bamford* is that in working out how much of a trust's net income (ie tax law income) is assessed to beneficiaries under s 97(1), a proportionate rather than quantum approach applies.

This was relevant when there was a difference between the "income of the trust estate" and the trust's "net income". For example, if a trustee determines that a capital gain was not income of the trust estate, the "net income" of the trust for tax purposes would have exceeded the "income of the trust estate" in that income year. The question was how this excess amount was to be taxed.

The High Court in *Bamford* applied the analysis of Sundberg J in *Zeta Force*, who stated:

> *263. Having identified the share of the distributable income to which the beneficiary is presently entitled, s 97(1) requires one to ascertain "that share of the net income of the trust estate". That share is included in the beneficiary's assessable income … The words "that share" in par (a)(i) refer back to the word "share" in the expression "a share of the income of the trust estate", and indicate that the same share is to be applied to an income amount calculated according to a different formula (taxable income as opposed to distributable income). Since the income amount may differ according to which formula is applied,* ***the natural meaning to give to "share" where it appears for the second time is "proportion" rather than "part" or "portion".*** (emphasis added)

Under the proportionate approach confirmed in *Bamford*, each beneficiary's share of the distributable income or "income of the trust estate" as a proportion (ie percentage or fraction) was to be applied to ascertain their share of the 'net income' of the trust. The outcome was that the excess amount was assessed proportionately amongst the beneficiaries who shared in the distributable income.

The alternative interpretation that existed prior to *Bamford* (the quantum approach) held that each beneficiary is only assessed on an amount (ie quantum) of the "net income" being the amount of "income of the trust estate" to which they are presently entitled. The outcome of this interpretation was that where "net income" exceeds "income of the trust estate", the excess is not attributable to any beneficiary and it is therefore assessed to the trustee under s 99A ITAA36.

---

2 *Bamford v FCT* [2009] FCAFC 66.

3 *Cajkusic v FCT* [2006] FCAFC 164.

4 *Zeta Force Pty Ltd v FCT* (1998) 39 ATR 277.

5 *Richardson v FCT* (2001) 48 ATR 101.

Example

Zeta Force Pty Ltd[6] provided the following illustration of the difference between the proportionate and quantum approaches:

279 ... An example will assist in the description of the competing approaches. A trust estate's distributable income is $60,000. An amount of $30,000, being a gain on the sale of property acquired after 19 September 1985, has been treated as an accretion to corpus and is not included in the distributable income. The $30,000 is however assessable for income tax purposes, so that the taxable income is $90,000. The trustee resolves to distribute 30% of the distributable income to X and 70% to Y.

One method is to assess X on 30% of $90,000 ($27,000) and Y on 70% of $90,000 ($63,000). This is appropriately described as the proportionate method. It treats the words "that share" in the phrase "that share of the net income of the trust estate" in s 97(1) as meaning a "fraction" or "proportion" and not an "amount". Because X is entitled to 30% of the distributable income, he will be taxed in respect of 30% of the taxable income. This method distributes the tax between X and Y proportionally, and there will be no amount on which the trustee will be liable to pay tax under s 99 or s 99A. The proportionate method may appear to operate unjustly, in that X and Y are taxed on amounts greater than they have received from or can demand of the trustee.

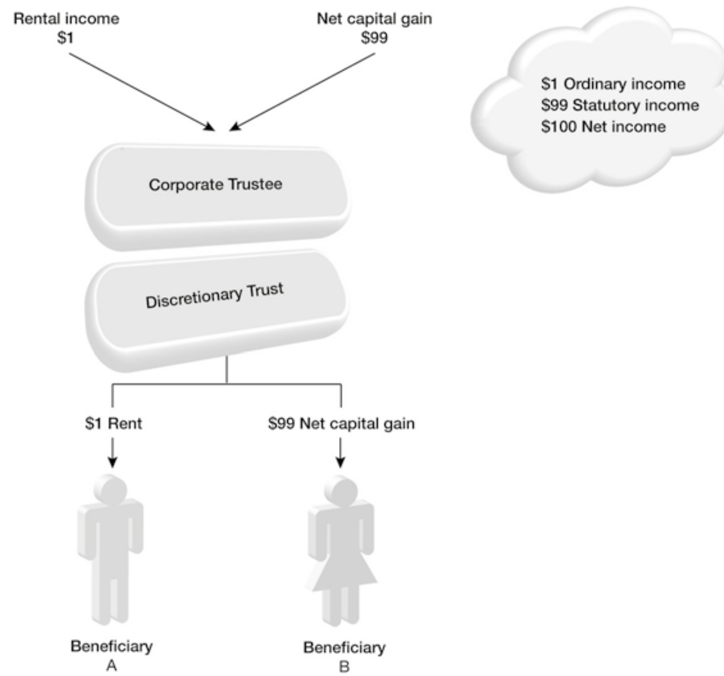
The alternative method is to assess X on 30% of $60,000 ($18,000) and Y on 70% of $60,000 ($42,000). The $30,000 balance is assessed to the trustee under s 99 or s 99A. This method taxes the beneficiaries on what they receive from or can demand of the trustee. It treats "that share" as meaning the share of the net income to which the beneficiary is presently entitled.

However, the High Court confirmed that the proportionate approach is the correct interpretation.

It has been acknowledged by the courts that in some circumstances the proportionate approach may produce seemingly unfair outcomes (although it has also been noted that unfair outcomes can result from the alternative quantum approach). The following case studies illustrate the effects of the proportionate approach when combined with the correct meaning of "income of the trust estate" as confirmed in *Bamford*. It is important to note that, as from the 2010-11 income year, the new interim measures described in ¶6-160 of this guide would apply in these examples and may alter the outcome.

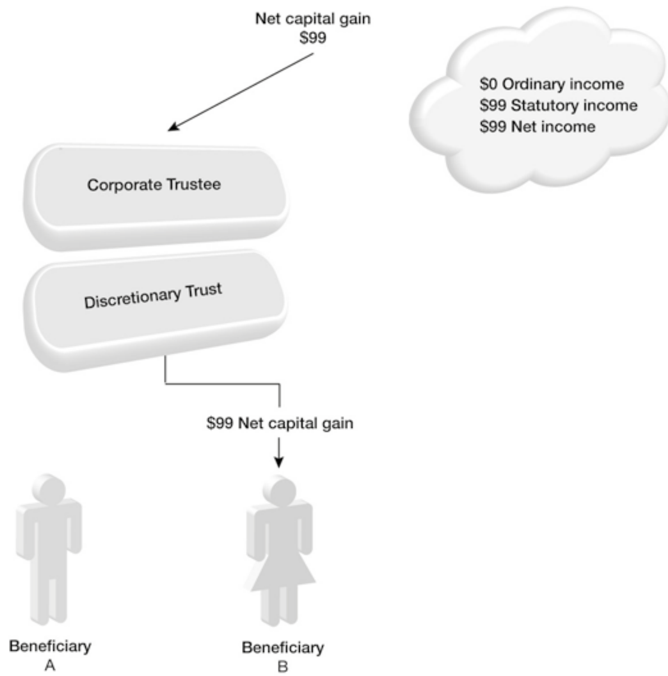
6 *Zeta Force Pty Ltd v FCT* (1998) 39 ATR 277

Example 1



Discretionary Trust has $1 rental income and $99 taxable net capital gain. The trust's deed defines "income" as income according to ordinary concepts. The rental income is appointed to Beneficiary A and the net capital gain is appointed to Beneficiary B. Under the proportionate approach, Beneficiary A has received 100% of the ordinary income and therefore 100% of the income of the trust estate (ie $1 rental income) so is taxable on 100% of the net income of the trust, which included the $99 net capital gain. Beneficiary A will be taxed on the rental income and net capital gain even though Beneficiary B is entitled to receive the net capital gain (effectively tax free).

Example 2



Discretionary Trust has no ordinary income but has a $99 taxable net capital gain. The deed provides that income of the trust is income according to ordinary concepts. Trustee Pty Ltd appoints the net capital gain to Beneficiary B. As there is no ordinary income, Trustee Pty Ltd cannot make an appointment of ordinary income so that a beneficiary has a present entitlement to the income of the trust estate under s 97 ITAA36. As no beneficiary is presently entitled to the income of the trust estate, Trustee Pty Ltd is taxable on the net income of the trust, being the capital gain, under s 99A ITAA36. This arises because the comparison is made only on "income" so appointment of "capital" does not affect the comparison.

The effect of the proportionate approach on the ability to stream classes of income and capital is discussed further at ¶6-160.

The effect of a beneficiary disclaiming their entitlement is discussed at ¶7-100.

¶6-115 Income according to trust law concepts

As there is now High Court authority that "income of the trust estate" means income according to trust law concepts, the task of identifying or determining that income is a critical step for trustees in each accounting period. The provisions of a particular trust's deed are crucial in this respect.

The process of ascertaining the income of the trust estate was explained in the *Bamford* decision of the Full Federal Court. (On appeal, the High Court did not comment on these matters but it ultimately upheld the Federal Court's decision.) Emmett J of the Federal Court stated that:

43. *The phrase "income of the trust estate" in the beginning of s 97(1) refers to distributable income. Distributable income is income ascertained by the trustee according to appropriate accounting principles and the relevant trust instrument and in accordance with the ordinary concept of income, which the 1936 Act adopts when it refers to "income".*

The trust's deed might impact the distributable income in several ways. It might expressly require that certain amounts be treated as either income or capital. In those circumstances, the provisions override any general principles. Emmett J explained that:

52. *… the first duty of a trustee is to comply with the terms of the instrument governing the relevant trust estate ... Thus, a trust instrument may contain provisions that determine the respective entitlements of beneficiaries in a way that is inconsistent with the principles concerning allocation to life tenants and remaindermen that would be applied under the general law. Where the relevant trust instrument expressly stipulates the entitlement of particular beneficiaries by, for example, specifying that receipts that would be for capital account under the general law principles are to be distributed to life tenant beneficiaries, that provision prevails and determines the amount which the respective beneficiaries are entitled to receive.*

Further, the trust's deed might provide the trustee with the power to determine whether receipts are to be treated as income or capital (and similarly whether outgoings are to be recorded against income or capital account). Emmett J further stated that:

59. *… where a trust instrument permits the trustee to treat a capital receipt as income for the purposes of fixing the entitlements of beneficiaries to distributions, a beneficiary who thereby becomes entitled to a share of that capital gain is presently entitled, within the meaning of s 97, to that part of the income of the trust estate. The beneficiary must include that share of the net income of the trust estate in that beneficiary's assessable income and the trustee would not be liable to be assessed under s 99A.*

Of course, the trustee cannot change whether a receipt will be included, for tax purposes, in the net income of the trust as defined in s 95 of the ITAA36. However, *Bamford* confirms that the trust's deed can define what is distributable income (ie "income of the trust estate") or it can provide the trustee with a power to determine whether a receipt forms part of that income.

TD 2015/D5

In June 2015, the ATO released TD 2015/D5, which considers the contrast between the expressions "share of the income of the trust estate" and "that share of the net income of the trust estate" analysed in the *Bamford* decision, in the context of whether an unpaid present entitlement (UPE) could be a "debt".

The ATO states in TD 2015/D5 that the *Bamford* decision confirms the analysis in *Zeta Force*[7] that the contrast between the expressions has sought to relate the concept of present entitlement to distributable income, and not to taxable income. Once the share of the distributable income to which the beneficiary is entitled is

7 *Zeta Force Pty Ltd v FCT* (1998) 39 ATR 277.

worked out, the notion of present entitlement has served the purpose, and the beneficiary is taxed on that share (or proportion) of the taxable income of the trust estate.[8]

The ATO refers to *Bamford* to conclude that, despite a trustee's equitable obligation to pay a UPE, a beneficiary is not entitled to a deduction under s 25-35 ITAA97 for a UPE that has been written off because that amount was not included in the beneficiary's assessable income in the relevant income year by virtue of it being a debt owing to the beneficiary. Rather, the beneficiary was assessed in that income year on "their share" of the taxable income of the trust.

So, despite the trustee's equitable obligation to pay the amount of the UPE (amount A) to the beneficiary, and the beneficiary including their share of the taxable income of the trust (amount B) in their assessable income for the relevant income year, the fact that amount B has a different conceptual genesis from amount A distinguishes it from amount A and prevents it from qualifying for a deduction under s 25-35(1)(a).

¶6-120 The scope of a trustee's power to determine income

The power to treat receipts as either income or capital can result in different tax outcomes. In many trust deeds, such a power is often expressed in broad terms and appears to confer a wide discretion on the trustee. This raises an important question about the extent to which a trustee can, as it sees fit, determine whether a given amount is income or capital.

In *Forrest,*[9] a Full Federal Court decision handed down two months before the High Court's decision in *Bamford*, a hybrid unit trust's deed provided that the trustee could determine whether a receipt or expense was on capital or income account. Under that deed, the trust's capital gains were to be held on trust for certain discretionary beneficiaries and all other income was to be held on trust for the unit holders.

The Commissioner of Taxation sought to deny deductions claimed by a unit holder for interest expenses incurred from borrowing to purchase units in the trust. The Commissioner argued that, due to the broad power of the trustee to determine income, it was not possible for the unit holder to know whether future dividends received by the trust would be treated as income (to which the unit holder would be entitled) or capital (which could not be distributed to unit holders).

The court found that the taxpayer's interest expenses were allowable deductions because the trustee's power to determine income was not unlimited (and therefore the taxpayer had an expectation that he would derive income from the units). The Federal Court stated that:

> *[27] the power conferred by cl 12 cannot be exercised by the trustee wrongly to classify a receipt as a capital gain, when the receipt is, in truth, income, and thus deprive the appellant of his interest in the unit component of the trust. Clause 12 is not an unlimited power to be exercised in the trustee's unconfined discretion.*

8 *FCT v Bamford* [2010] HCA 10 at [45].

9 *Forrest v FCT* [2010] FCAFC 6.

> *[28] … Clause 12.1 is a power to make an honest administrative determination whether receipts are on capital account or income account. It is not a power to determine, in the trustee's unconfined discretion, whether a receipt "represents realised or unrealised capital gains". It is that fact which determines whether components of the trust fund are held on trust for the discretionary beneficiaries or the Unit Holders.*

The court found that the trustee did not have an unfettered discretion but merely a power to determine whether an amount is income or capital *according to law*. However, the court was clear that this was the correct interpretation when the power to determine income was read in the context of the rest of the trust's deed; the power to determine income was not unfettered having regard to the rights expressly conferred on unit holders by other clauses.

As discussed above, the High Court in *Bamford* held that "income of the trust estate" means income according to trust law but it did not expressly comment on the *Forrest* issue, ie whether and in what context the trustee's power to determine income is restricted. The income determination powers in the deeds in *Bamford* and *Forrest* were similar but, importantly, the trusts created by those deeds were not the same.

In a decision made after the High Court's decision in *Bamford*, the New South Wales Court of Appeal in *Clark v Inglis*[10] found that movements in the value of investments (unrealised gains) could be treated as income for trust purposes. It reached this conclusion despite there being no specific power to do so in the trust deed and no definition of income that contemplated such amounts being included within the income of the trust. When making its determination, the court considered that as the question was "of a business and accounting character in usage and concept, the court should pay heed to the principles, practice and approach of commercial accountancy".[11] It is important to note that although there was no specific power in the trust deed to make such a determination there was a general power in relation to determining whether any property or money was held as income or capital. Further, the case was not a tax case but rather one concerning the proper administration of estates.

More recently, based on the specific terms of a trust deed under consideration, the NSW Court of Appeal[12] held that, based on the terms of the Ernst & Young Services Trust deed, the trustee had a discretion as to how much income (if any) may be applied by the trustee in each financial year, up to the maximum set by the accounting income recorded in the annual accounts, with the word "arising" emphasising that the income from the trust fund arises during the course of each financial year.[13] Therefore, the trustee was permitted under the terms of the trust deed to make interim distributions of "income". Each interim payment into the joint account was a dispositive act and the resolutions passed by the directors at the end of each financial year were confirmatory rather than dispositive of the interim payments preceding the date of the resolutions.[14]

---

10 *Clark v Inglis* [2010] NSWCA 144.

11 Ibid at [39].

12 *Segelov v Ernst & Young Services Pty Ltd* [2015] NSWCA 156.

13 Ibid at [90].

14 Ibid at [96].

ATO position on determination of income

Despite recent developments, the ATO's statements about the extent to which a trustee can determine income suggest that the ATO might not yet fully accept the kind of flexibility that was ultimately endorsed by the High Court in *Bamford*.

The ATO reminds taxpayers in the *Forrest* decision impact statement (*Forrest* DIS),[15] the more recent *Bamford* decision impact statement (*Bamford* DIS)[16] and PS LA 2010/1 (released in response to *Bamford* and discussed at ¶6-130) that a trustee's power to determine income is not necessarily an unfettered discretion. While this is true, it is questionable whether it is correct or appropriate to re-state the *Forrest* decision as part of the *Bamford* DIS and PS LA 2010/1. It is important not to overlook the significant fact that the *Bamford* decision, from the highest court in Australia, has upheld a trustee's decision to treat a capital gain as income in the context of a discretionary trust where no beneficiaries have entrenched rights (unlike *Forrest*).

Further, prior to the *Forrest* and *Bamford* litigation the ATO had taken the view in the *Cajkusic* decision impact statement (*Cajkusic* DIS)[17] that the income of the trust is income according to ordinary concepts and that the trust deed cannot deem statutory income (such as a capital gain) to be income of the trust. While the *Cajkusic* DIS has now been amended to clarify that it no longer represents the ATO's view in this respect and that the *Bamford* DIS reflects its current view, the *Bamford* DIS reminds us that a trustee's power to determine income is not necessarily an unfettered discretion. In the *Bamford* DIS, the ATO also suggests that it still places some reliance on the *ANZ Savings Bank Ltd* decision (see note below).

Therefore, the High Court's failure to expressly comment on the trustee's power to determine income, when coupled with the ATO's recent reminders that the power to determine income is not an unfettered discretion and its apparent reluctance to concede the *ANZ Savings Bank Ltd* decision, creates some doubt about the ATO's acceptance of the trustee's power to determine income.

TR 2012/D1

In 2012, the ATO released TR 2012/D1 which seeks to administratively constrain the flexibility provided in *Bamford* when determining distribution income by holding that the statutory and trust law context restricts the concept of "income of the trust estate" despite the terms of the trust deed. This approach is largely unsupported by legislation or judicial authority. In the draft ruling, the ATO asserts, despite the terms of the trust deed, that:

- income of the trust estate must be calculated by reference to distinct tax income years;[18]
- income and trust estate are distinct concepts so income must be the product of the trust estate[19] and income applied to corpus in a previous year cannot be reclassified as income for a current year;[20]

15 ATO decision impact statement, *Forrest v FCT*, 4 May 2010.

16 ATO decision impact statement, *FCT v Phillip Bamford & Ors*; *Phillip Bamford & Anor v FCT*, 2 June 2010.

17 ATO decision impact statement, *Cajkusic v FCT*, 12 September 2007.

18 TR 2012/D1 at para 9.

19 TR 2012/D1 at para 8.

20 TR 2012/D1 at paras 10–11.

- income of the trust is net income, not gross income;[21] and
- notional income amounts (franking credits, additional trust distributable income referable to the proportionate approach, the market value substitution rules, private company deemed dividend rules and controlled foreign company or transferor trust rules) may only constitute income of the trust estate to the extent of any set-off of notional expenses.[22]

The ATO position that income must be cash or a current year accretion to the trust fund restricts the ability for trustees to manage notional amount and loss trust distributions and creates unexpected or unnecessary distribution management issues.

The requirement that income be a current year accretion to the trust fund limits the ability to reclassify an asset revaluation reserve, previously accumulated income corpus or settlement corpus as income so that there is some net distributable income to which a beneficiary can be presently entitled to prevent tax attribute lock-up.

The ATO considers that the statutory and trust law context restricts the concept of "income of the trust estate" despite the terms of the trust deed and *Bamford*.[23] Therefore, the ATO has stated that, although the trust deed can shape the definition of income, the statutory and trust law context operates as a cap on what the income of the trust estate can be for Div 6 purposes.

Effectively, the ATO's approach renders inoperative or reduces the flexibility of powers provided in the trust deed to manage unintended consequences of the proportionate approach and taxation of statutory income, and constitutes a recasting of the arguments already rejected in *Bamford*.[24]

Some commentators had expressed doubts about the ATO's views prior to the *Bamford* and *Forrest* litigation. The ATO's reasoning in TR 2012/D1 has also been extensively criticised,[25] and has raised further concerns, namely, whether:

- the ATO's reliance on the settlor's intention to restrict the operation of the trust is based on an antiquated view in respect of modern drafted discretionary trust deeds;
- the reliance on the statutory context to limit the flexibility provided by the trust deed is contrary to *Bamford*;[26]
- the ATO's reliance on the trust law context to limit the flexibility provided by the trust deed is contrary to trust law authorities that the rules are overridden by the terms of the trust deed;

21 TR 2012/D1 at para 12.

22 TR 2012/D1 at paras 15–17.

23 *FCT v Bamford* [2010] HCA 10.

24 *FCT v Bamford* [2010] HCA 10.

25 For example. see GS Cooper and A White, Thomson Reuters *Weekly Tax Bulletin*, Issue 17, 27 April 2012; Law Council of Australia submission TR 2012/D1, 24 May 2012.

26 *FCT v Bamford* [2010] HCA 10.

- it is logically inconsistent to assert that statute can limit the trust deed's operation but the trust deed's operation cannot be expanded to deal with statutory income concepts (such as notional amounts); and
- the ATO incorrectly applies the judicial comments in *Forrest*[27] and *Colonial*[28] generally, despite those cases being limited to the unusual terms of the relevant trust deeds.

To the extent that *Bamford* is considered not to have answered the question of the extent to which a trustee can determine income, it is worthwhile recalling the arguments that existed prior to those recent cases.

Note

The Full Federal Court's decision in *Cajkusic* recognised a trustee's power to determine income and rejected the ATO's argument that trust law income cannot be governed by what is said in the trust deed. The ATO then rejected the *Cajkusic* analysis on the grounds that it was inconsistent with *ANZ Savings Bank Ltd*[29] and *Totledge*[30] or that it was merely non-binding obiter dicta.[31] However, some commentators criticised the ATO's reliance on these cases, which were considered to be applied by the ATO out of context.

Further, the Full Federal Court in *Bamford* has since held that *Cajkusic* is binding. It is unfortunate for taxpayers, practitioners and the ATO that the High Court did not see fit to expressly comment on these issues. However, as the High Court ultimately upheld the decision of the Full Federal Court and did not express any reservations or doubts about that decision, it appears there is implicit High Court support for the reasoning of the Full Federal Court and, similarly, the analysis in *Cajkusic*.

Conclusion

The weight of authority suggests that the trust instrument can determine by classification and reclassification what is income of the trust estate. Although the High Court in Bamford was silent on this issue, *Zeta Force*, *Richardson, Cajkusic* and the Full Federal Court in *Bamford* have unambiguously stated that the trust instrument can determine by classification and reclassification what is income of the trust estate. Although a literal reading of statements in *ANZ Savings Bank Ltd* and *Totledge* supports the ATO, when considered in context those statements do not unambiguously support the ATO's contentions. Further, the decision in *Forrest* can be distinguished from the facts of *Bamford* as it involved a fundamentally different type of trust with different entrenched rights to capital and income. The ATO's suggestion that the trustee's power is not unfettered must be considered in the different contexts of those cases.

In any event, trustees and practitioners should be aware that the ATO has stated that it will actively follow up on attempts to exploit the *Bamford* decision. (This is discussed in further detail ¶6-140.)

27 *Forrest v FCT* [2010] FCAFC 6.

28 *Colonial First State Investment Ltd v FCT* [2011] FCA 16.

29 *FCT v ANZ Savings Bank Ltd* (1998) 39 ATR 419 (HC).

30 *FCT v Totledge Pty Ltd* (1982) 12 ATR 830.

31 ATO decision impact statement, *Cajkusic v FCT*, 12 September 2007.

¶6-125 The role of documentation

The *Bamford* decision has highlighted the importance of documentation for trusts. The provisions of a trust's deed will be critical. Further, trustees will also be required to pay close attention to distribution resolutions and other documentation recording how income is determined, identified and appointed.

The trustee must be alert to the income and distribution provisions in the deed by identifying issues such as:

- how "income" and "capital" are defined (if at all);
- whether the deed expressly requires that certain receipts and/or expenses are to be recorded on revenue or capital account;
- whether the deed provides the trustee with a power to determine what is income of the trust fund or how expenses may be treated;
- whether the deed provides a default that applies in the event that the trustee fails to make a determination as to what is income or how expenses are to be treated (eg some deeds state that unless the trustee determines otherwise, income of the trust fund is the net income of the trust as defined in s 95 ITAA36);
- whether the deed permits the trustee to recognise and deal separately with different sources or categories of income or capital;
- whether the proposed recipients of income or capital are in fact beneficiaries of the trust. Some deeds allow the trustee to nominate additional persons or entities as beneficiaries. In this case, a trustee resolution purporting to nominate a person as beneficiary might not be sufficient to validly nominate the beneficiary, depending on the particular provisions of the trust's deed; and
- whether a default appointment applies if the trustee fails to make a valid determination (eg income is accumulated or held for default beneficiaries). There may be important 30 June timing issues that impact when the trustee must make a determination in order to avoid a default appointment.

These issues need to be examined before the trustee resolves to accumulate or distribute any amounts. In particular, where the trustee is given a power to determine income and capital, it will be important to have sufficient evidence of how the trustee has exercised that power.

At its simplest, many trust instruments since the introduction of capital gains tax have sought to equate the income of the trust estate with s 95 ITAA36 so there are no inconsistencies under the proportionate approach, by adopting clauses similar to:

> ***"income"*** *means the net income of the Trust Fund for an Accounting Period calculated in accordance with section 95(1) ITAA 36.*

While such clauses may be effective in certain scenarios there are as yet unresolved issues in relation to the implementation of such clauses where the income of the trust for tax law purposes includes "notional" amounts.

If the trust instrument does not reclassify income or empower the trustee to reclassify income, then any purported reclassification will likely be ineffective.

Variation of trust deeds

In some cases, it will be desirable to amend the trust's deed, provided the trustee has power to do so. Whether an amendment will trigger a trust resettlement is an important consideration. The ATO has provided some guidance as to what constitutes a valid variation of a trust deed in TD 2012/21.

TD 2012/21 provides that CGT event E1 (which occurs when a new trust is created over a CGT asset) or CGT event E2 (which occurs when a CGT asset is transferred to a trust) does not happen if, pursuant to a valid exercise of a power contained within the trust's constituent document, the terms of the trust are changed. According to the determination, CGT event E1 or E2 only occurs in relation to an amendment where that amendment results in the trust being terminated for trust law purposes, or where the effect of the amendment is to lead to a particular asset being subject to a separate charter of rights and obligations such as to give rise to the conclusion that that asset has been settled on terms of a different trust:

> *20. It is clear following Clark that, at least in the context of recoupment of losses, continuity of a trust estate will be maintained so long as the trust is not terminated for trust law purposes. As such, in the absence of termination, tax losses being carried forward by a trustee will as a general rule remain available to be recouped against relevant trust income derived in future years of income.*
>
> *21. Furthermore, as a general proposition, it would seem that the approach adopted by the Full Federal Court in Commercial Nominees, as explained by Edmonds and Gordon JJ in Clark,[3] is authority for the proposition that assuming there is some continuity of property and membership of the trust, an amendment to the trust that is made in proper exercise of a power of amendment contained under the deed will not have the result of terminating the trust, irrespective of the extent of the amendments so made so long as the amendments are properly supported by the power …*

The ATO considers that the test to be applied looks to whether changes to one or more of the trust's constituent documents, the trust property, and the identity of those with a beneficial interest in the trust property are such as to terminate the existence of the trust. The ATO has provided examples of valid variations of trust deeds in TD 2012/21, which were accepted as not having a resettlement CGT consequence.

The risk of resettlement in specific states or territories is a further consideration as this could trigger a stamp duty liability. Advice should therefore be sought before undertaking any variation to a trust deed.

When resolving to distribute amounts, trustees should also be mindful of recent ATO developments in the administration of Div 7A to unpaid present entitlements. This may require that the documentation of how amounts are set aside (both in the deed and in trustee minutes) be given careful consideration.

Effective exercise of discretions

The exercise of the trustee's powers should be effected by properly drafted documentation. Implied exercise of the trustee's reclassification powers by simple treatment in the accounts could be insufficient to effect the reclassification. Clear expressed exercise of the power of reclassification is necessary (eg in the trustee's minutes).

Often appointments of income are made to persons as beneficiaries without any reference to the trust deed, or alternatively, there is simply a resolution of directors of a corporate trustee purporting to nominate a person as beneficiary when that action will not be sufficient to achieve the desired outcome.

In *Richardson*, the Full Federal Court discussed the formality required to exercise the determination as follows:

> [52] *It was open to the tribunal to find that the entries in the balance sheet and the profit and loss statement did not establish an exercise of the trustee's discretion under cl 7(m) of the trust deed, notwithstanding that the latter part of cl 7(m) makes it clear that a determination under the clause need not be "made upon a question formally or actually raised" and may be "implied in any of the acts or proceedings of the Trustee in relation to the Trust Fund". A determination by the trustee was not required to be in, or evidenced by, any particular form. The tribunal did not suggest otherwise, but found, and was entitled to find, that the documents before it did not establish a determination. As Finkelstein J suggested, the entries in the balance sheet and the profit and loss statement are consistent with a view that a determination under cl 7(m) was unnecessary.*
>
> [53] *Is any error shown in Finkelstein J's holding that the appellant was "presently entitled" to a share of the income of the trust estate? I do not think that there is.*

However, in *Cajkusic*, the Full Federal Court adopted a less stringent formality by the statement:

> [20] *As evidenced by the financial accounts ... Intex, consistently with the power vested in cl 8(u) of the deed, treated the outgoings in question as being on revenue account. By the same clause, it had the power to effectively deny the outgoings that characterisation by determining that the income of the trust ... shall be its s 95 "net income" for that year, but there is no evidence that it exercised that power.*

In *Bamford* (AAT 2007),[32] the Administrative Appeals Tribunal acknowledged that the evidence did not indicate clearly that the trustee had determined to reclassify capital as income. The purported reclassification was ambiguous but the Administrative Appeals Tribunal determined there had been an effective determination. In the *Bamford* Full Federal Court decision, it was observed:

> 26 *The Company made no express determination pursuant to Clause 7(n) of the Bamford Trust Deed that any capital gain was to be treated as being on income account. However, it is common ground that, pursuant to clause 7(n) of the Bamford Trust Deed, the Company treated as income available for distribution a capital gain arising from the sale of real property.*

The High Court similarly accepted that it was common ground that the trustee has treated a capital receipt as income available for distribution. However, it is worth noting that the contest in the *Bamford* litigation focused on the meaning of "income of the trust estate" and not what is required to effect a valid exercise of trustee power.

¶6-130 ATO response to recent developments

The ATO has provided some administrative guidance following the landmark *Bamford* decision.

Division 6 generally

PS LA 2009/7 was published in 2009 to assist taxpayers following the Full Federal Court's *Bamford* decision but prior to the High Court litigation. That practice statement was based on the ATO's view at the time that "income of the trust estate" meant ordinary income (which could not be altered by a trust's deed or a

32 *Bamford and P and D Bamford Enterprises Pty Ltd in its capacity as the Trustee of the Bamford Trust and FCT* [2008] AATA 322.

determination by the trustee), notwithstanding that there was Full Federal Court authority that this was not the case. Following the High Court litigation, PS LA 2009/7 was withdrawn with effect from 2 June 2010 and replaced by PS LA 2010/1. The 2010 practice statement generally accepts the recent High Court authority.

As previously discussed in ¶6-120, TR 2012/D1 sought to address some of the complexities associated with the meaning of "income of the trust estate" in Div 6 generally and as modified in Div 6E. The ATO holds that the statutory and trust law context restricts the concept of "income of the trust estate" despite the terms of the trust deed and *Bamford*.[33] Therefore, the trust deed can *shape* the definition of income of the trust but the statutory and trust law context operates as a cap on what the income of the trust estate can be for Div 6 purposes.[34] The ATO's approach in the draft ruling is largely unsupported by legislation or judicial authority and seeks to administratively constrain the flexibility provided by *Bamford* when determining distributable income.

The ATO has stated that it will not actively seek to disturb returns for 2009-10 and earlier years where taxpayers have relied on a view that was reasonably open prior to *Bamford*. However, if a return is examined for other reasons and adjustments are to be made, the ATO states that adjustments must be made on the basis of *Bamford* principles. The ATO has recognised that taxpayers in this situation will generally have a reasonably arguable position and will have taken reasonable care insofar as *Bamford* issues are concerned.

However, the ATO has flagged that it will investigate any deliberate attempts to exploit Div 6. This is discussed in further detail at ¶6-140.

Capital gains

The ATO previously released PS LA 2005/1 (GA) which outlined approaches to the taxation of a trust's net capital gain which the ATO will accept in certain circumstances. This includes potentially unfair situations where:

(1) a beneficiary who has no interest in the trust's capital gain would be assessed on part of the trust's net capital gain under s 97(1) due to the proportionate approach; or

(2) a beneficiary has an interest in the trust's capital gain but no beneficiary is entitled to any of the trust's distributable income and the net capital gain is therefore assessed to the trustee under s 99A at the highest marginal tax rate.

In these situations, the ATO broadly accepted that potentially unfair tax outcomes could be overcome by allocating the trust's capital gain to relevant beneficiaries no later than two months after the end of the income year (subject to some additional requirements being met; refer to PS LA 2005/1 (GA)). In the first case, this would ensure that the beneficiaries have an entitlement to the capital on which they are taxed. In the second case, the ATO would allow the beneficiary to be taxed instead of the trustee.

This practice statement now only has effect for the 2009-10 and earlier income years. However, trustees and practitioners should note that the ATO has stated in its *Bamford* DIS that if these issues arise in a dispute, the ATO must apply the current law and PS LA 2005/1 (GA) might only provide a reasonable basis for settling a tax dispute.

33 *FCT v Bamford* [2010] HCA 10.

34 TR 2012/D1 at para 13.

For 2010-11 and future income years, trustees with inflexible income provisions should consider whether the trust's deed can be amended to provide the trustee with greater flexibility to ensure trust capital gains do not create potentially unfair tax outcomes.

¶6-135 Federal government response to recent developments

On 4 March 2011, the Assistant Treasurer and Minister for Financial Services and Superannuation, the Hon. Bill Shorten, MP, released a discussion paper titled "Improving the taxation of trust income".

The discussion paper outlined proposals to amend the tax law concerning trusts for the 2010-11 income year. While the discussion paper acknowledged that there would be a public consultation process prior to a wholesale rewrite of the trust income tax provisions, it stated that the government had decided to immediately implement interim reforms after examining advice from the Board of Taxation.

The amendments were to:

- align distributable income with taxable income; and
- ensure that capital gains and franked distributions can be streamed to particular beneficiaries.

As may be expected, any interim reforms to address issues as complex as those concerning the taxation of trusts will inevitably lead to unintended taxation consequences. This is acknowledged in the discussion paper where the Assistant Treasurer noted that "it will be possible to show anomalous outcomes under any of the interim approaches".

The discussion paper proposed to insert a definition of "income of the trust estate" (distributable income) into Div 6 ITAA36. The paper then identified three options as to how that definition may be drafted being:

(1) defining distributable income using tax concepts;

(2) defining distributable income using accounting concepts; or

(3) defining distributable income to specifically include capital gains.

The discussion paper provided greater detail on the first option than the other two. The paper noted that an option one definition could not directly equate distributable income with taxable income. It acknowledged that any such definition would need to provide for adjustments to taxable income to take into account both notional income and expenses.

Each of the options operates by then considering whether a present entitlement has been created to the newly defined distributable income.

Timing

In order to avoid potential undesirable and unintended consequences generally and for different types of trusts (fixed and managed investment trusts as opposed to discretionary trusts), professional bodies requested deferral and further consultation regarding the options to rectify distributable income and taxation income distinctions.

On 6 April 2011, the Assistant Treasurer (at the Institute of Chartered Accountants in Australia National Tax Conference) announced the deferral of the "income" definition component of the current amendments into the broader review.

Streaming and the Tax Laws Amendment (2011 Measures No. 5) Act 2011

The discussion paper also proposed legislative amendments to support streaming of capital gains and franked dividends to be effective from the 2010-11 income year. The amendments only address the relevant provisions of the taxation law and still require an appropriate power in the trust deed itself in order for taxpayers to take advantage of the ability to stream income with different tax characteristics to different beneficiaries. Indeed, the relevant examples in the discussion paper explicitly stated that streaming in those examples is effected in accordance with powers in the trust deed "to identify separate classes of income and, in making any appointment of income to the beneficiaries, to specify the class of income from which that entitlement will be met".

The *Tax Laws Amendment (2011 Measures No. 5) Act 2011* (TLAA No. 5), which received royal assent on 29 June 2011, introduced the interim provision Div 6E ITAA36 which modifies the operation of Div 6 and streaming capital gains and franked distributions, and enacted trust distribution anti-avoidance provisions for the year ended 30 June 2011. These interim provisions significantly affect the approach to trust distributions. See ¶6-160 for a further detailed consideration of the TLAA No. 5.

On 21 November 2011, the Assistant Treasurer and Minister for Financial Services and Superannuation, the Hon. Bill Shorten, MP, issued a consultation paper titled "Modernising the taxation of trust income — options for reform". The closing date for submissions was 10 February 2012.

The consultation paper outlined current issues impeding the effective operation of Div 6, as well as other issues that impede the effectiveness of the taxation of trusts generally. The government stated in the paper that any reform developed would be within the broad policy framework currently applying to trusts which reflects the following five principles:

(1) tax liabilities in respect of the income and gains of a trust should "follow the money" in that they should attach to the entities that receive the economic benefits from the trust;

(2) the provisions governing the taxation of trust income should be conceptually robust, so as to minimise both anomalous results and opportunities to manipulate tax liabilities;

(3) the provisions governing the taxation of trust income should provide certainty and minimise compliance costs and complexity;

(4) it should be clear whether amounts obtained by trustees retain their character and source when they flow through, or are assessed, to beneficiaries; and

(5) trust losses should generally be trapped in trusts subject to limited special rules for their use.

Some of the key issues that were identified as impeding the effective operation of Div 6 ITAA36 and the effective taxation of trusts were:

- the concepts of "distributable income" and "taxable income" of a trust;
- the method for allocating taxable income of the trust to either the beneficiaries or the trustee; and
- whether trust receipts retained their character and source.

These issues will be considered in turn below.

The concepts of distributable income v taxable income of a trust

The concept of taxable income refers to the "net income of the trust estate" and is defined in s 95 ITAA36 as:

> *the total assessable income of the trust (including capital gains) less allowable deductions, calculated as if trustee were a resident taxpayer.*

The concept of distributable income refers to the "income of the trust estate" and was confirmed by the High Court in *Bamford* as being calculated with reference to general trust law principles and having regard to the relevant trust deed and accounting principles.

The "income of the trust estate" therefore depends on provisions in the trust deed.

There are a number of unresolved issues as to what constitutes the "income of the trust estate". These include:

- how to treat notional amounts such as franking credits, deemed dividends, deemed capital gains, Pt IVA amounts, Div 41 and 43 deductions;
- how to treat expenses where beneficiaries are entitled to different classes of income; and
- whether a trustee can treat income receipts as capital receipts.

In the past, these issues have sought to be overcome through income equalisation clauses (that equate the distributable income to the taxable income) and re-classification clauses (which give the trustee the power to classify receipts and outgoings as income or capital).

Method for allocating taxable income of the trust to either the beneficiaries or the trustee

In *Bamford*, the High Court confirmed that the proportionate approach was the correct approach to s 97 ITAA36.

Section 97 states, broadly, that where a beneficiary who is not under a legal disability is presently entitled to a share of the income of the trust, the assessable income of that beneficiary shall include so much of that share of the net income of the trust estate as is attributable to that beneficiary.

Bamford confirmed that once the share of the distributable income of the trust to which a beneficiary is presently entitled is determined, the beneficiary will be assessed on that same proportion of the trust's taxable income.

A beneficiary is presently entitled where that beneficiary has a vested and indefeasible interest in any of the income of the trust estate (s 95A(2) ITAA36 and *Harmer v FCT* (1991) 173 CLR 264).

Present entitlement must be determined by 30 June each year.

The problem arises with the application of s 97 to exempt and non-assessable non-exempt (NANE) income. Using *Bamford's* proportionate approach, where such amounts form part of the trust's distributable income, a beneficiary who is presently entitled, will be entitled to a proportion of the trust's taxable income. This is so even if the beneficiary may only be entitled to amounts that are exempt or NANE income.

Whether trust receipts retain character and source

The conduit theory is the notion that the character of an amount in the hands of the trustee is retained when distributed to the beneficiaries. This theory was subject to ongoing debate but was endorsed generally in the decision in *Greenhatch and FCT* [2011] AATA 479. However, the decision was overturned on appeal to the Full Federal Court. An application for special leave to appeal to the High Court of Australia was dismissed on 10 May 2013.

"Streaming" refers to the trustee's power to direct different types of income to different beneficiaries of the trust.

Following *Bamford's* confirmation of the proportionate approach, it was unclear whether streaming was still possible, and whether a beneficiary was to be assessed on a proportionate share of the "blended" amount of the taxable income of the trust.

Interim measures in TLAA No. 5 provide that, where permitted by the trust deed, capital gains and franked distributions may be streamed to beneficiaries specifically entitled to those amounts (retaining character for tax purposes).

The Full Federal Court decision in *Greenhatch* requires a beneficiary to include in assessable income a "blended" amount of all of the different types of income and capital gains included in the trust's taxable income. Accordingly, the beneficiaries of any trust that has differently streamed capital gains for the period prior to 1 July 2010 will have incorrectly recorded the taxation treatment of that distribution and so have an exposure to audit activity, amended assessments and penalties.

PS LA 2010/1 at para 10 states:

> *Because there had been considerable uncertainty before the decision in Bamford about the principles applicable to the operation of Division 6, it may be expected that some taxpayers will have lodged tax returns and/or administered their trusts on the basis of views that, with the benefit of the decision in Bamford, may be seen to be wrong. Accordingly, staff undertaking active compliance activities in respect of the 2009-10 and earlier income years should not select cases for active compliance just to correct such errors. However, if there is a deliberate attempt to exploit Division 6 (see paragraph 11 of the practice statement) or cases are selected for other reasons (for example, because there is a dispute about the quantum of the [tax] net income), and adjustments are to be made, the adjustments must be made on the basis of the law as explained in Bamford.*

The Commissioner of Taxation will not be undertaking active compliance for the 2009-10 and earlier income years to correct differential capital streaming, unless there is a deliberate attempt to exploit Div 6 or the matter is selected for other reasons.

PS LA 2010/1 provides limited protection from audit expansion, shortfall penalties and interest charges because PS LA 2010/1 is not administratively binding on the Commissioner of Taxation as with rulings, and does not make any statements regarding tax penalties or other relevant issues that can be relied on by a taxpayer as protection against shortfall penalty or interest charges.

Options for reform

The government's stated intention in the consultation paper is that the taxable income of a trust will continue to be assessed primarily to beneficiaries, with trustees being assessed and liable to pay tax only to the extent that taxable income is not assessed to beneficiaries.

The Treasury consultation paper discussed three option models for reform:

"Patch" model

Under the "patch" model, the existing structure of Div 6 will be retained and will include a definition of "income of the trust estate" for tax purposes.

There are four options for the treatment of expenses:

(1) prescription by legislation (especially for allocation against different classes of income);

(2) codification of the common law principle for apportionment on a fair and reasonable basis;

(3) maintaining the status quo – attribution on a fair and reasonable basis based on the relationship between the outlay and assessable income; or

(4) inclusion in the definition of distributable income.

"Proportionate within class" model

Under the "proportionate within class" model, it is proposed that the beneficiary is to be assessed on a proportionate share of the taxable income of each class.

There are a number of steps to be followed, including determining and allocating distributable income to the different classes of income allowed under the trust deed, calculating taxable income and allocating it to the classes, and determining the beneficiary's share of each class of taxable income based on proportionate entitlement.

Under this model, a definition of "distributable income" may be required and a trustee may be required to maintain classes of income which correspond with tax law classifications. Specific rules may also be required to cover general expenses and specific expenses incurred in deriving income of a specific class, and the treatment of losses at a class level.

The advantages of this model include continuity of existing concepts and character flow-through and streaming.

The disadvantages of this model include reliance on trust law conceptions, the need to interpret individual trust deeds, increased complexity and compliance costs for trusts which do not distinguish between classes of income.

"Trustee assessment and deduction" model

The "trustee assessment and deduction" model is similar to the US, Canadian and New Zealand models. It involves calculating the taxable income of the trust, identifying the distributions that have been made to beneficiaries and the unallocated amounts. The trustee will be assessed on the taxable amounts that are retained in the trust.

It is proposed that in order to provide certainty in relation to character and source, all amounts that are distributed in the year that are first recognised for tax purposes, would retain their character and source in the hands of beneficiaries. This principle would give effect to "streaming" where the trustee has the power to do so, rather than conferring the power to stream.

The advantages identified with this model include:

- reduced complexity and compliance costs due to the removal of detailed trust concepts;
- reduced reliance on individual trust deeds; and
- a reduced scope for beneficiaries to be taxed on amounts that they are not entitled to under trust law.

This model could however increase the scope for trustee assessments and is also a significant departure from the current operation of Div 6.

The reforms to the taxation of trusts provisions in Div 6 ITAA36 have been delayed until 1 July 2014. (The proposed reforms in tax law relating to trusts are discussed in further detail in ¶7-100.)

On 24 October 2012, the Assistant Treasurer also released a policy options paper in relation to the scope of the proposed reforms on the trust taxation rules and how trusts should be taxed (the options paper). The options paper provides an update in relation to the proposed reforms and includes a discussion on the ability to stream various categories of income. In particular, the options paper further discusses the intricacies of two proposed models, the "economic benefits model" (EBM) and the "proportionate assessment model" (PAM).

The following table is extracted from p 9 of the options paper which summarises aspects of the two models.

CURRENT LAW	EBM	PAM
1. Basis for assessment		
Beneficiaries are assessed on a share of the trust's net income, based on their present entitlement to a share of the income of the trust estate. Trustees are assessed on net income that is not assessed to beneficiaries.	Beneficiaries are assessed on amounts distributed or allocated to them that represent amounts of the trust's taxable income. Trustees are assessed on amounts representing taxable income that are not distributed or allocated to beneficiaries.	Beneficiaries are assessed on a share of the trust's taxable income based on their present entitlement to a share of the trust profit or class amounts. Trustees are assessed on taxable income that is not assessed to beneficiaries.
2. Character retention and streaming		
Capital gains and franked distributions can be streamed to beneficiaries. These amounts retain their tax character when assessed to beneficiaries.	Amounts representing the trust's taxable income retain their tax character when distributed or allocated to beneficiaries, except where other parts of the tax law limit character retention. All amounts can be streamed to beneficiaries.	Classes of taxable income assessed to beneficiaries retain their tax character, except where other parts of the tax law limit character retention. All amounts can be streamed to beneficiaries.
3. Time for determining entitlements		
Trustees must determine beneficiary entitlements by 30 June, other than entitlements to capital gains, which may be determined up to 31 August.	Trustees must declare distributions and allocations to beneficiaries by 31 August.This does not mean amounts must actually be paid by that date.	Trustees must determine beneficiary entitlements by 31 August.

Despite the focus on the two models illustrated above in the options paper, Treasury has not ruled out adopting the "patch model" that was described in the initial Treasury consultation paper outlined above.

Taxpayers will need to await the release of the exposure draft legislation to determine which approach is to be adopted by the government and how any new proposed model will ultimately operate. Consultation is ongoing and seemingly unlikely to change in the very near future.

¶6-140 Part IVA ITAA36 general anti-avoidance

Where a taxpayer obtains a tax benefit under a scheme and the taxpayer or some other person entered into the scheme for the sole or dominant purpose of the taxpayer obtaining the tax benefit, the ATO may disregard and reconstruct the scheme and tax the taxpayer on the subsequent basis (Pt IVA ITAA36 (Pt IVA)).

Part IVA was amended in 2013, with amendments applying to schemes entered into, or commenced to be carried out, on or after 16 November 2012. The amendments focus on the concept of "tax benefit".

Potential application to trusts

If the trust law authorities when determining the income of the trust estate apply generally or to specific classes of modern trusts, then applying those authorities to allocate income, capital and outgoings and to defer recoupment of losses without more is arguably of itself not a scheme or undertaken for the dominant purpose of the taxpayer obtaining a tax benefit.

Normally the proportionate approach may result in a beneficiary being taxable on an amount to which the beneficiary cannot demand payment from the trustee. However, there is generally not a loss of tax revenue as the beneficiary must pay the tax.

In response to recent developments, the ATO has flagged that it will investigate deliberate attempts to exploit the flexibility which *Bamford* confirms is possible under the Div 6 taxation regime. Examples given by the ATO of exploitative practices include:

- characterising expenses which would ordinarily be capital in nature on income account, thereby reducing the trust's distributable income to a nominal amount which is appointed to loss beneficiaries. As 100% of distributable income is appointed to loss beneficiaries, all of the trust's tax law income is effectively tax free. The ATO has concerns that this is, in effect, accumulated income that would ordinarily be assessed to the trustee at the highest rate; and
- characterising the majority of a trust's ordinary income as capital and amending the deed to include tax-exempt charities as beneficiaries who are then appointed the nominal distributable income, with capital receipts distributed to family members. As 100% of distributable income is appointed to tax-exempt charities, all of the trust's tax law income is effectively tax free.

Recently, in the case of *Track and FCT* [2015] AATA 45, the AAT held that Pt IVA applied to a scheme carried out by several taxpayers (who were natural persons and the ultimate beneficiaries of the trust's income) to take advantage of the CGT small business concessions. The case involved applications to amend assessments that arose out of a capital gain made by the corporate trustee (Track Co) of several units when it sold its business for over $8m in July 2005. At issue was whether the anti-avoidance provisions of Pt IVA operated to cancel the tax benefits obtained in connection with the scheme to satisfy the maximum net asset value test under Subdiv 152-C and Subdiv 152-B ITAA97.

The AAT held that no explanation was provided as to how any of the steps in the scheme contributed to the taxpayer's asserted motive of asset protection. Even the evidence of a need for asset protection was unconvincing. It noted that the complexity of the scheme pointed to the purpose of obtaining a tax benefit, and the timing of the distributions of each trust pointed to the purpose of meeting the CGT concession threshold. The scheme was entered into for the purpose of obtaining a tax benefit, which was ultimately the concessional CGT treatment that reduced Track Co's capital gain considerably. The AAT said that the scheme was an artifice and did not come anywhere near "reasonably arguable". Therefore, Pt IVA operated to cancel the tax benefit of the taxpayers.

The TLAA No. 5 enacted the exempt entity anti-avoidance provisions which deems a tax exempt entity not to be presently entitled to income if the trustee failed to pay or notify the entity in writing of the present entitlement (s 100AB ITAA36) or where the exempt entity is not specifically entitled to the capital gain or franked distribution with effect from 1 July 2010.

The charity must be notified by 31 August after the end of the income year of the present entitlement. For trustees (such as testamentary trusts or public trustees) that have managed investments, the trustee may be unable to comply with this requirement because distribution statements from the managed investment manager are generally not received until September. A legislative amendment or administrative concession is required.

TA 2013/3

On 12 August 2013, the ATO issued a taxpayer alert warning about the use of artificial arrangements where an individual purports to make the trustee of a discretionary trust a partner in a firm of accountants, lawyers or other professionals. The ATO's concern with this type of arrangement, and others with features substantially equivalent, is whether they fail to give legal effect to the transactions or fail to account for their tax consequences, and mainly whether the general anti-avoidance rules in Pt IVA apply to cancel tax benefits obtained by the individual. TA 2013/3 cautions that these arrangements, which have been designed to avoid the payment of tax on the large taxable capital gain, may constitute a scheme to which Pt IVA applies. In addition, the ATO warns that the entity involved in these arrangements may be a promoter of a tax exploitation scheme for the purposes of Div 290 of Sch 1 of the *Taxation Administration Act 1953*.

TA 2013/1

TA 2013/1 (which deals with trust income mismatch arrangements) is one aspect of the work which the Trusts Taskforce will focus on. Among other aspects, the Taskforce targets higher-risk taxpayers that seek to "exploit trusts to conceal information, mischaracterise transactions and artificially deal with trust income to avoid or reduce tax".

TA 2013/1 discusses arrangements involving a deliberate mismatch between the amounts that beneficiaries are entitled to receive from a trust and the amounts that they are taxed on. It describes the situation where a trust generates a small amount of income and a large capital gain. One beneficiary receives a distribution of the funds generated from the capital gain, while a new incorporated company receives the tax liability attached to that gain. As the newly incorporated company receives no funds to pay the associated tax liability, it is wound up. This process is designed to avoid the payment of tax on the large taxable capital gain. The ATO is reviewing such arrangements to determine whether it is (among other things) a sham or a scheme to which Pt IVA could apply.

PS LA 2005/24

In August 2015, the ATO issued its revised draft of PS LA 2005/24, which provides guidelines to ATO staff in relation to the application of the general anti-avoidance rules, including Pt IVA. PS LA 2005/24 discusses the operation of Pt IVA and the Commissioner's position on the "alternative postulate" as it applies both prior to, and after, the 2013 amendments, noting that the ATO "has very little practical experience in applying the amendments in real cases".[35]

35 PS LA 2005/24 at para 71.

Trustees should also consider the following "Pt IVA warning signs" provided in PS LA 2005/24. The ATO considers such signs as indicating that an arrangement may be "tax driven" and entered into for the dominant purpose of enabling a taxpayer to obtain a tax benefit:[36]

- the arrangement (or any part of the arrangement) is out of step with ordinary family dealings or arrangements ordinarily used to achieve the relevant commercial objective;
- the arrangement seems more complex than is necessary to achieve the relevant family or commercial objective;
- the arrangement includes steps that appear to serve no real purpose other than to gain a tax advantage;
- the tax result of the arrangement appears at odds with its commercial or economic result;
- the arrangement results in little or no risk in circumstances where significant risks would normally be expected;
- the taxpayer's risk is significantly limited as a result of the arrangement;
- the parties to the arrangement are operating on non-commercial terms or in a non-arm's length manner; and
- there is a gap between the substance of what is being achieved under the arrangement and its legal form.

¶6-145 Conduit theory: common law principles

Charles v FCT[37] is traditionally cited to assert that the character of income or capital flows through the trust to the beneficiaries:

> *But a unit under the trust deed before us confers a proprietary interest in all the property which for the time being is subject to the trust of the deed: Baker v Archer-Shee; so that the question whether moneys distributed to unit holders under the trust form part of their income or of their capital must be answered by considering the character of those moneys in the hands of the trustees before the distribution is made.*

The conduit theory (to the extent it is based on *Charles v FCT*) is arguably limited to unit trusts where the unit holders have a beneficial interest in the assets of the trust.[38]

It is logical that if the beneficiary owns a share of the asset, then the class of income and tax attribute associated with the asset is directly derived by the beneficiary. However, this principle will arguably not apply to modern unit trusts or discretionary trusts where the unit holders do not have a beneficial interest in the assets of the trust. Where there is no such beneficial interest what is distributed is income or capital in a generic sense, not dividend income, discounted capital gain etc.[39]

---

36 PS LA 2005/24 at para 140.

37 (1954) 90 CLR 598 at 609.

38 Compare *Clowes v FCT* (1954) 91 CLR 209; *Milne v FCT* 76 ATC 4001; *Syme v CSR (Vic)* (1914) 18 CLR 519; and *FCT v Tadcaster Pty Ltd* 82 ATC 4316 at 4319.

39 *FCT v Angus* [1960] 105 CLR 489; G Longhouse, "Maintaining identity: the conduit theory of the taxation of trust income", *The Tax Specialist*, vol 2(3), February 1999, at p 132.

CPT Custodian Pty Ltd v CSR (Vic) (High Court 2005),[40] although a land tax case, created uncertainty regarding whether the conduit theory can apply at all. The court made the following observations regarding the nature of a fixed trust:

> [36] *The deed considered in Charles divided the beneficial interest in the trust fund into units (cll 6 and 7), and the trustees were bound to make half-yearly distributions to unitholders, in proportion to their respective numbers of units, of the "cash produce" which had been received by the trustees (cll 13A and 13B). Karingal and CPT rightly stress that the deeds with which this litigation is concerned were differently cast and in terms which do not support any direct and simple conclusion respecting proprietary interests of unitholders such as that reached in Charles.*
>
> [49] *… In the deed, the manager covenanted with the trustee (cl 23.4) to ensure that there were at all times sufficient readily realisable assets of the trust available for the trustee to raise the fees to which the manager and the trustee were entitled under cl 23.1 and cl 23.2 respectively. These stipulations made the trustee and the manager interested in due administration of the trusts of the deed, in the sense identified by Kearney J in Moses Montefiore. Put somewhat differently, the unitholders were not the persons in whose favour alone the trust property might be applied by the trustee of the deed.* (footnotes omitted)

The conduit theory may no longer apply to unit trusts where the beneficiary does not have a beneficial interest in the assets of the trust or the trustee has an entitlement to receive additional fees of a personal capacity.

CPT Managers Ltd v CSR (NSW)[41] made the following observations qualifying *CPT Custodian Pty Ltd v CSR (Vic)*:

> [50] *There is nothing in CPT nor in the later decision of the High Court in Halloran v Minister Administering National Parks and Wildlife Act 1974 (2006) 80 ALJR 519 that suggest that the holder of a unit in a unit trust lacks an equitable interest in the trust property.*
>
> [55] *Under the old Chancery practice, any beneficiary was entitled, as of right, to have the trust administered by the Court of Chancery and to that end to obtain a decree for general administration (McLean v Burns Philp Trustee Co Pty Ltd (1985) 2 NSWLR 623 at 633-638). But that right arose because the beneficiary had an interest in the trust that needed protection. If the "beneficiary" lacked any equitable interest in the trust, there was nothing to protect and, contrary to the Chief Commissioner's submission, there was no entitlement to due administration. A person in that position is a stranger to the trust and cannot be regarded as a beneficiary.*

Reconciling *CPT Custodian Pty Ltd v CSR (Vic)* and *CPT Managers Ltd v CSR (NSW)* (or the divergence in treatment) is difficult because there is no normative relationship that constitutes a unit trust.[42] Arguably, the differences can be reconciled because *CPT Custodian Pty Ltd v CSR (Vic)* commented on proprietary interest in the assets, while *CPT Managers Ltd v CSR (NSW)* concerns equitable interests in the trust property. The cases are dealing with the distinction between the different phrases beneficial ownership, beneficial interest, beneficial entitlement, equitable interest and equitable ownership which are not mutually interchangeable.[43]

40 *CPT Custodian Pty Ltd v CSR* (2005) 60 ATR 371.

41 *CPT Managers Ltd v CSR* (2006) 64 ATR 654.

42 AH Slater, QC, "Unit trusts: law and lore" (2006) 35 Australian Tax Review 185.

43 R Speed, "Beneficial ownership", (1997) 26 Australian Tax Review 34.

The conduit theory may only apply to trusts sufficiently similar to *Charles v FCT* but will not apply to modern unit trust deeds similar to that in *CPT Custodian Pty Ltd v CSR (Vic)* because the beneficiaries may not have sufficient interest in the underlying assets of the trust.

Under the common law, the conduit theory would not apply to a discretionary trust.

Unless a specific statutory provision deems the character of income to flow through a modern unit trust or discretionary trust, it is unclear whether provisions in the trust instrument can effect this.

¶6-150 Statutory conduit theory

Section 6B ITAA36 deems a person to be in receipt of dividends, passive income, interest and other sources of income where the person derives the amount of income as a beneficiary in a trust estate and the amount of income can be attributed directly or indirectly to that type or source of income. For example, s 6B ITAA36 states:

> ***6B INCOME BENEFICIALLY DERIVED***
>
> ***(2A)*** ***[Income derived from particular source]*** *For the purpose of this Act, an amount of income derived by a person shall be deemed to be income derived from a particular source:*
>
> *(a)* *except where paragraph (b) applies:*
>
> *(i)* *...*
>
> *(ii)* *if the person derived the amount of income as a beneficiary in a trust estate and the amount of income can be attributed, directly or indirectly, to income derived from that source or to an amount that is deemed, by any other application or applications of this subsection, to be an amount that is income derived from that source; or*
>
> *(b)* *...*
>
> ***(3)*** ***[presently entitled beneficiary]*** *Where a beneficiary in a trust estate is presently entitled to income of the trust estate, that income shall, for the purposes of this section, be deemed to be an amount of income derived by the person.*

Section 6B(3) ITAA36 provides a legislative basis for the conduit theory. Particularly, s 6B(3) deems a presently entitled beneficiary to "income of the trust estate" for that income to retain its character. Accordingly, the ATO is correct that income retains its character as it flows through the trust to the beneficiaries for s 97 ITAA36 purposes.

Notably, s 6B ITAA36 provides flow-through for income amounts, but makes no reference to capital amounts. It is submitted that:

- a capital receipt will retain its character under the common law conduit theory where the trust is sufficiently similar to *Charles v FCT* so it will not be possible to recharacterise it as income of the trust estate for s 97 ITAA36 purposes; or
- any other capital receipt will not be deemed to retain its character under the common law conduit theory and s 6B(3) ITAA36 will not apply so there is no impediment to the recharacterisation of the capital receipt as income of the trust estate for s 97 ITAA36 purposes.

The flow-through treatment of capital gains is discussed in more detail in ¶6-160.

¶6-155 ATO views on conduit theory

The *Bamford* DIS outlined the ATO's view that, subject to express taxation provisions, the proportionate approach endorsed by the High Court does not depend on the character or class of income to which beneficiaries are entitled. That is, each beneficiary's share in the net income of the trust represents an "un-dissected or un-allocated" proportionate entitlement.

The implication is that, but for any statutory provision (eg s 6B ITAA36), each beneficiary shares in a proportionate amount of *each class* of income.

¶6-160 Federal government response to recent developments and the TLAA No. 5

As noted at ¶6-135 above, the discussion paper titled "Improving the taxation of trust income" released by the Assistant Treasurer and Minister for Financial Services and Superannuation, the Hon. Bill Shorten, MP, on 4 March 2011 specifically addressed streaming.

The discussion paper outlined proposals to amend the tax law concerning trusts for the 2010-11 income year. While the discussion paper acknowledged that there would be a public consultation process (ie the consultation paper titled "Modernising the taxation of trust income — options for reform" that was released on 21 November 2011) prior to a wholesale rewrite of the trust income tax provisions, it stated that the government had decided to immediately implement interim reforms after examining advice from the Board of Taxation.

The interim reforms were introduced by the TLAA No. 5, which received royal assent on 29 June 2011 and was effective from 1 July 2010. The TLAA No. 5 enacted the complex Div 6E which amended the capital gains and franked distribution flow-through provisions to "enable" streaming.

Broadly, the TLAA No. 5:

- enacted Div 6E which modifies the operation of Div 6 by excluding capital gains and franked distributions for the calculations of amounts under ss 97 to 100 ITAA36;
- enacted the exempt entity anti-avoidance provisions which deem a tax exempt entity not to be presently entitled to income if the trustee failed to notify the exempt entity in writing of the present entitlement or where the exempt entity is not specifically entitled to the capital gain or franked distribution (see ¶6-140 above); and
- amended the capital gains tax provisions and franked distribution provisions to tax those amounts under Subdiv 115-C ITAA97 and Subdiv 207-B ITAA97.

Division 6E

Division 6E applies if a trust has net income which includes a capital gain or franked distribution (including franking credit), to calculate the income of the trust estate, the net income of the trust estate and the present entitlement of a beneficiary to exclude the capital gain and franked distribution (including franking credit). If the trust does not have net income or net income which includes a capital gain or franked distribution (including a franking credit), Div 6E makes no modification.

Division 6E effectively replaces the terms "presently entitled", "income of the trust estate", and "net income of the trust estate" with "Division 6E presently entitled", "Division 6E income of the trust estate", and "Division 6E net income of the trust estate". Each definition excludes a capital gain or franked distribution (including franking credit).

If the trust has net income which includes a capital gain or franked distribution (including franking credit), s 97 ITAA36 (for example) is relevantly interpreted as if it states:

> *97 Beneficiary not under any legal disability*
>
> *(1) … Where a beneficiary of a trust estate … is* ***Division 6E presently entitled*** *to a share of the* ***Division 6E income of the trust estate****:*
>
> *(a) the assessable income of the beneficiary shall include:*
>
> *(i) so much of that share of the* ***Division 6E net income of the trust estate*** *as is attributable to a period when the beneficiary was a resident; and*
>
> *(ii) …*

The "Division 6E income of the trust estate" and the "Division 6E net income of the trust estate" disregard the capital gain and franked distribution (including franking credit). The amount of a beneficiary's "Division 6E present entitlement" is decreased by the beneficiary's share of the capital gain and franked distribution included in the income of the trust estate.

Through the process of disregarding or decreasing capital gains and franked distributions, those amounts are then taxed under Subdiv 115-C ITAA97 (capital gains) and Subdiv 207-B ITAA97 (franked distributions).

The interaction between Div 6E and Subdiv 115-C ITAA97 (capital gains) and Subdiv 207-B ITAA97 (franked distributions) has altered the potential liability to tax of certain amounts of income.

Broadly, Div 6 operates to tax:

- the presently entitled beneficiary not under a legal disability on the net income of the trust at marginal or corporate tax rates;
- the trustee on behalf of the presently entitled beneficiary under a legal disability on the net income of the trust at marginal tax rates; or
- the trustee on the net income of the trust to which no beneficiary is presently entitled.

Broadly, Div 6E operates differently to tax:

- the specifically entitled beneficiary on the capital gains or franked distributions of the trust at marginal or corporate tax rates;
- the Div 6E presently entitled beneficiary not under a legal disability on the Div 6E net income of the trust at marginal or corporate tax rates (ie income other than capital gains and franked distributions);
- the Div 6E presently entitled beneficiary not under a legal disability on a proportion of the capital gains or franked distributions of the trust to which no beneficiary is specifically entitled;

- the trustee on behalf of the Div 6E presently entitled beneficiary or specifically entitled beneficiary under a legal disability on the net income of the trust at marginal tax rates; or
- the trustee on the net income of the trust to which no beneficiary is Div 6E presently entitled or specifically entitled.

Simplified, where there is no beneficiary specifically entitled to a capital gain or a franked distribution, the beneficiaries which are entitled to other classes of income are proportionately taxed on the capital gain or franked distribution (a continued form of transferred tax liability). It is only where there are no other classes of income or there are no beneficiaries presently entitled to those classes of income that the trustee is taxable under s 99 or 99A ITAA36.

Streaming of capital gains

A beneficiary of a trust estate (s 97 ITAA36) or a trustee of a trust estate (s 98 ITAA36) has a share of a capital gain that is the amount of the capital gain to which the beneficiary or trustee is "specifically entitled" plus a proportionate share of any capital gain to which no beneficiary or trustee is specifically entitled, based on the beneficiary's proportion of adjusted Div 6 percentage to the income of the trust (s 115-227 ITAA97).

Effectively, any capital gain to which no beneficiary or trustee is specifically entitled is taxable proportionately to the beneficiaries who received trust income (other than capital gains and franked distributions).

A beneficiary is "specifically entitled" to a capital gain made by the trust estate calculated by the formula:

$$\text{Capital gain} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

"Share of net financial benefit" means the amount of "financial benefit" that, in accordance with the terms of the trust, the beneficiary has received or is reasonably expected to receive which is referable to the capital gain and recorded in its character as referable to the capital gain in the trust's accounts no later than two months after the end of the income year (eg by 31 August).

A "financial benefit" is anything of economic value, including property or services. No beneficiary or trustee can be specifically entitled to a notional capital gain (a market value substitution gain), so notional capital gains are taxable proportionately to the beneficiaries that received income.

The financial benefit is referable to an amount "received" or "reasonably expected to be received" (s 115-228 ITAA97).

A beneficiary is reasonably expected to receive an amount if the beneficiary is presently entitled to the amount, the beneficiary has a vested and indefeasible interest in the trust property representing the amount or the amount has been set aside exclusively for the beneficiary (para 2.45 of the explanatory memorandum to the TLAA No. 5.

The amendments correct the problem that taxable capital gains could not be distributed where there was no trust accounting income unless the trust deed contained an income equalisation clause or receipts reclassification clause. A specific entitlement will be created regardless of whether the capital gain is appointed under the income clause or capital clause of the trust deed by the operation of s 115-215 ITAA97. The same result is achieved because Div 6E disregards the capital gain included through Div 6.

However, this legislative approach that a capital gain to which no beneficiary is specifically entitled is taxed proportionately to the beneficiaries that have received the Div 6E income may have unforeseen consequences. Where the Div 6E income has been distributed to a corporate beneficiary, the capital gain will be taxable to that corporate beneficiary without the 50% CGT discount.

Trustee resolutions

There are a number of matters that must be taken into consideration as a result of the new Div 6E, one of which is the nature of the resolution required as a result of the TLAA No. 5.

The nature of the resolution required will be dependent on whether the trust deed contains an income equalisation clause or receipts reclassification clause. Where the trust deed contains these clauses, the taxable and non-taxable capital gain will be appointed to a beneficiary under the income distribution clause in the trust deed. If the trust deed does not have these clauses, the taxable and non-taxable capital gain will be appointed under the capital distribution clause.

The TLAA No. 5 also requires that the trustee record the "in its character as referable to the capital gain" in the trust's accounts no later than two months after the end of the income year (eg by 31 August). Generic trustee resolutions that appoint "the balance" of trust income, "all of the trust income", "half of the trust income", or "$100 of trust income" have not specifically recorded the character even if factually the appointment contains some or consists entirely of a capital gain. Accordingly, a detailed specific resolution is required that refers to the character of the income and not just generic trust income.

Assessable and non-assessable component of a capital gain

As a result of the amendments there is now a requirement that the non-assessable component of a capital gain be distributed to the same person as the assessable component of the capital gain (refer to para 2.51 of the explanatory memorandum to the TLAA No. 5.

The requirement to make a beneficiary entitled to both the assessable component of a capital gain and the non-assessable component of a capital gain could, for example, have any of the following implications:

- the use of trust structures previously utilised to stream the assessable component of a capital gain which was reclassified as income and distributed to a different class of beneficiaries to the non-assessable component of a capital gain;
- the need for resolutions to adequately address both the assessable and non-assessable component of a capital gain;
- the presence of a significant individual (a "small business participation percentage" of at least a 20% entitlement to income and capital) for the purposes of accessing the small business CGT concessions.

Historically, it was often the case that the assessable capital gain was reclassified as income and distributed as income of the trust estate to establish the income participation percentage. The non-assessable component of the capital gain was distributed in the following income year so as not to adversely reduce the small business participation percentage. The amendments require the assessable and non-assessable capital gain to be distributed in the same income year to the same beneficiary. Where differential streaming occurs (Beneficiary A receives income (including reclassified capital gains) and Beneficiary B receives non-assessable capital gains) the participation percentages may be adversely affected and the trust may not have at least one significant individual.

Loss recoupment

The provisions of the TLAA No. 5 require capital losses to be applied on a gain-by-gain basis so gain attribution and loss allocation rules must be applied. The explanatory memorandum to the TLAA No. 5 states:

> *2.84 This calculation applies on a "gain-by-gain" basis for each capital gain of the trust.*
>
> …
>
> *2.86 … For the purposes of determining specific entitlement only, the losses (a trust concept) must be applied in a way that is consistent with how the trustee applies capital losses for tax purposes.*
>
> …
>
> *2.91 … Consistent with the CGT regime, the trustee can choose the order in which they apply the losses. This may reduce the taxable amount for a particular capital gain to zero.*
>
> *2.92 However, in some circumstances, taxpayers rateably reduce the taxable amount of the capital gain to ensure that beneficiaries and the trustee are not assessed on more than the total taxable income of the trust.*

It is therefore essential that care is taken to ensure that capital losses are applied in the same way for trust purposes and tax purposes to avoid a mismatch of financial benefits (refer to para 2.50 of the explanatory memorandum to the TLAA No. 5.

Streaming of franked distributions

The amendments to Subdiv 207-B ITAA97 broadly correspond with the approach adopted by the TLAA No. 5 in respect of capital gains tax. Accordingly, a full analysis is not undertaken and repeated.

The legislative approach is that a franked distribution to which no beneficiary is specifically entitled is taxed proportionately to the beneficiaries that have received the Div 6E income. If there is no beneficiary entitled to receive the Div 6E income, the trustee is taxed on the amount.

Unlike capital gains:

- a trustee can appoint franked distributions as a single class. However, if the trustee does not pool all the franked distributions and attempts to specifically stream certain franked distributions to particular beneficiaries, then the single class rule will not apply and the trustee must appoint franked distributions on a dividend-by-dividend basis;

- the trustee must reduce the franked distribution class of income by all directly related expenses.

The franked distribution provisions did not expressly permit the trustee to record the distribution "in its character as referable to the franked distribution" in the trust's accounts no later than two months after the end of the income year (eg by 31 August). Accordingly, the recording of the distribution will have to occur prior to 30 June each year. However, the ATO has stated the ATO will provide an administrative concession for the 2010-11 income year so that the recording of a franked distribution may take place no later than two months after the end of the year.

Further, the ATO has withdrawn IT 328 and IT 329 effective from the 2011-12 and subsequent income years. IT 328W and IT 329W provided trusts with the administrative concession to create present entitlements through resolutions up to 31 August following the end of the income year.

Amendment to trust deeds

The explanatory memorandum to the TLAA No. 5 makes it clear that the trust deed must include a streaming power to undertake differential streaming. A flexible definition of income under an income equalisation clause or receipts reclassification clause may assist in creating the necessary specific entitlement to a capital gain or a franked distribution.

While most modern discretionary trust deeds contain an adequate streaming clause and an income equalisation clause or receipts reclassification clause, trust deeds should be reviewed, and if necessary amended, to include these powers.

Public consultation process

Following the discussion paper titled "Improving the taxation of trust income" and introduction of the TLAA No. 5 as discussed above, the consultation paper titled "Modernising the taxation of trust income – options for reform" that was released on 21 November 2011, further proposes two different approaches to reduce the uncertainty with respect to character flow-through and streaming.

The first approach is to include a generic rule allowing for character retention for amounts received via a trust.

The second approach is more prescriptive, with the tax law having specific rules allowing for character retention for specific income types.

The effect of the streaming will depend on:

- the approach taken for character retention; and
- whether an amount is "allocated" to a particular beneficiary for tax purposes.

Under both approaches, the trustee must have the ability under the terms of the trust deed to identify and distribute particular types of income and gains.

¶6-165 Greenhatch

Administrative Appeals Tribunal decision

The Administrative Appeals Tribunal in *Greenhatch and FCT* [2011] AATA 479 (*Greenhatch*) held that selective capital streaming was effective prior to the amendments by the TLAA No. 5.

The Administrative Appeals Tribunal decision in *Greenhatch* went so far as to endorse the conduit theory generally and applied the conduit theory to a discretionary trust. The tribunal also considered the effectiveness of streaming franked distributions and dividends, interest and royalty income.[44]

The tribunal held that there was no presumption that s 115-215 ITAA97 operates on a proportionate share basis in the same way as s 97 ITAA36 operates because, while s 97 ITAA36 speaks in terms of "shares", s 115-215 ITAA97 speaks in terms of "parts (if any)".

Further, the ATO's proportionate share approach would render the words "(if any)" otiose and each beneficiary of the trust would be proportionately assessed on the capital gain. Also, the section proceeds on the footing that each capital gain is addressed, suggesting that the section differentiates between beneficiaries who are entitled to particular parts of particular gains.[45]

The wider system of taxing income derived by trustees, such as dividend, interest and royalty withholding[46] and franked distributions,[47] suggests a look-through approach fastening on a particular character of amounts to which beneficiaries are entitled.

Importantly, the tribunal stated:

> 64. *The conclusion that we reach is that s 115-215 of ITAA97 is a section that the legislature enacted at a time before there was any caution directed to the decision of the High Court in Charles which is consistent with a suite of provisions that identify:*
>
> *(a) particular amounts of income or capital gains of trust estates;*
>
> *(b) beneficiaries' particular entitlements to those amounts; and*
>
> *(c) recognise those amounts in the hands of the beneficiaries with the same character as they had in the hands of the trustee.*
>
> 65. *Where the terms of the trust allow identification of who is entitled to what, in our view the legislature intended that the taxation treatment follow on a differentiated basis among beneficiaries.*

Full Federal Court appeal decision

In *FCT v Greenhatch* [2012] FCAFC 84, the Full Court allowed the Commissioner's appeal, and held that:

---

44 R Jorgensen, "Greenhatch v FCT: streaming – much ado about nothing", (2011) 46(2) *Taxation in Australia* 785.

45 *Greenhatch and FCT* [2011] AATA 479 at [37].

46 S 128A(3) ITAA36.

47 S 207-5 ITAA97.

- s 97(1)(a) ITAA36 includes in assessable income as the "trust amount" a proportionate share of amounts having no single character;[48]
- "the part of the trust amount attributed to the trust gain" in s 115-215(3)(b) ITAA97 must be given a share/proportionality construction consistently with s 97 ITAA36;[49]
- once s 97 ITAA36 trust law distribution gave the share/proportion, it should not be used to determine, in a causative sense, the components of the s 97(1)(a) ITAA36 assessable income;[50] and
- the words "part (if any)" in s 115-215(3)(b) ITAA97 may have been included from an abundance of caution and are inapt to qualify the proportionate relationship as a non-proportionate concept.[51]

Accordingly, the Full Court held that a beneficiary's assessable income under s 97 ITAA36 consisted of an undissected proportionate share of the entirety of the trust's taxable income, that is, a "blended"' amount. Each beneficiary of the trust would be treated as having an extra capital gain (and other classes of income), even though they had no entitlement to the capital gains of the trust under the trust deed.

High Court special leave application

On 1 August 2012, Mr Greenhatch applied for special leave to appeal to the High Court of Australia.

In the application for special leave, the taxpayer asserted that:

- the scheme of the Acts was that the liability of a beneficiary to tax on income depended not only on the amount of the beneficiary's share or interest (the only issue in *Bamford*), but also on the character or quality of the distributable income and how for trust law purposes that income was distributed;
- each of the non-resident beneficiary (s 98A ITAA36), exempt income (s 97(1)(b) ITAA36), non-assessable, non-exempt income (s 97(1)(c) ITAA36), dividend, interest or royalty withholding (ss 128A, 128AF and 6B ITAA36), foreign tax credits (ss 770-130(3) and 770-10 ITAA97), franked dividends (s 207-35 ITAA97) and capital gains (s 115-215 ITAA97) provisions was concerned with fixing the liability to tax according to the beneficiary's entitlement to a share, or individual interest, in what was attributable and a construction under which some provisions treated a receipt as retaining its character while others resulted in an undifferentiated pro-rated allocation of the character did not achieve a construction with a harmonious result;
- the Full Federal Court misapplied the reasoning in *Bamford* and ascribed to "attributable" in s 115-215 a simple proportionate allocation based on quantity, regardless of the position at trust law and without the necessary nexus of character or source of income; and
- special leave should be granted because the fiscal consequences of differential streaming potentially affected a significant proportion of the 700,000 trusts lodging tax returns in Australia and the proportional

48 *FCT v Greenhatch* [2012] FCAFC 84 at [31] and [35].

49 Ibid at [36].

50 Ibid at [36].

51 Ibid at [40] referring to [36].

allocation issue was equally applicable to the TLAA No. 5 provisions because there was no material difference between the meaning of “attributable to” and “referable to” in the new provisions.

On 10 May 2013, the High Court (Crennan and Keane JJ) dismissed the application for special leave because no question of law or public importance was raised and there were insufficient prospects of success on any appeal to warrant the grant of special leave.

ATO’s view on the decision

On 19 July 2013, the ATO released an impact statement on the Full Federal Court decision, stating that the decision had answered the question of how statutory flow-through provisions interacted with the general trust-taxing provisions in Div 6 of Pt III ITAA36, given that a beneficiary’s liability to be assessed on the tax net income of the trust under Div 6 may not correspond with the beneficiary’s actual entitlement to income of the trust, by reference to Subdiv 115-C ITAA97.

The ATO concluded that, as Subdiv 115-C ITAA97 was amended in 2011 to facilitate the tax-effective streaming of capital gains made by trusts, the court’s construction of Subdiv 115-C is only significant in relation to the operation of the provisions prior to the 2011 amendments.

The ATO notes that, absent specific rules in the income tax legislation that lead to different results (such as Subdiv 115-C), the character for trust law purposes of the income to which the beneficiary was made presently entitled does not inform the character of the share of the net income assessed to the beneficiary under s 97 ITAA36 for tax law purposes. The streaming of amounts for trust law purposes by reference to the character of those amounts will only be effective for tax law purposes where that result is facilitated by specific statutory rules.

¶6-170 Summary

The High Court’s decision in *Bamford* resolved a number of fundamental issues about the operation of Div 6. In particular, it confirmed that there is potential flexibility when determining the “income of the trust estate” and depending on particular circumstances this could give rise to different taxation outcomes. Moving forward the ATO will need to rely on specific and general anti-avoidance provisions to protect the revenue.

While the provisions of the TLAA No. 5 achieve the desired outcome in respect of the ability to stream capital gains and franked distributions (provided the trust deed includes the necessary powers) the provisions are complex and require careful consideration to ensure the intended specific entitlement is created and, importantly, that unintended consequences are not triggered.

For each trust, it remains the case that the degree of flexibility depends on the extent of the trustee’s powers. The provisions of the trust deed and preparation of documentation such as distribution minutes will therefore be critical to implementing effective distributions. These issues have sometimes been overlooked in the past but will necessarily attract greater scrutiny as a result of *Bamford* and the TLAA No. 5.

¶6-175 When is there likely to be a problem?

Although these issues should ideally be addressed every time a trust distribution is made, the following is a list of circumstances in which difficulties may arise:

- the trust receives exempt income;
- the trust has a taxable capital gain;
- the trust incurs non-tax deductible expenses which are treated in the accounts as income expenses;
- the trust incurs tax deductible expenses which are treated in the accounts as capital expenses;
- the trust makes a prepayment which is tax deductible in the current financial year but not treated as an income expense until the subsequent financial year;
- the trust claims tax deductions which may be later disallowed or reduced;
- the trust does not declare income which may later be held to be assessable; and
- the trust has accounting losses which are not sufficiently matched by carry-forward tax losses to ensure no tax is payable.

This list is not exhaustive.

¶6-180 What to do?

The problems presented by Div 6 ITAA36 have only been exacerbated over time as trust deeds attempt to deal with more and more complicated tax concepts such as the basic treatment of capital gains as statutory income, the more sophisticated treatment of capital gains reduced by tax concessions in Divs 115 and 152 ITAA97 or through tax credits attaching to franked dividends passing through a trust that has made the requisite family trust elections and passed the relevant holding period rules.

Modern trust structures attempt to deal with these issues and others relating to the treatment of income and capital through a variety of means including:

- Sophisticated definitions of income that do more than simply assume income is to be determined in accordance with ordinary concepts but rather allow the trustee the flexibility to treat receipts and other amounts as income or capital for the purposes of the trust as the trustee sees fit.
- Default provisions that provide that income of the trust is to be determined in accordance with the s 95 ITAA36 definition of net income if the trustee fails to make an alternative determination.
- Clauses empowering the trustee to separately record various categories of income and capital and then to distribute from those categories income and capital to which attaches a particular characteristic to one beneficiary to the exclusion of the others.
- Provisions permitting the allocation of outgoings against such categories of income with such tax characteristics as the trustee thinks fit.
- Clauses permitting the trustee to recoup losses as they consider appropriate including for example out of capital or out of profit generated in subsequent years.

- Empowering the trustee to accumulate any or all of the income derived in a particular year rather than to appoint that income to beneficiaries.

Subject to the comments above regarding the current uncertainties in administering Div 6 ITAA36, the operation of a properly drawn trust deed and minutes may combine to avoid any unintended consequences.

The following checklist may assist:

- Make sure that the trust deed is adequate and, in particular, ensure that it contains:
  - a proper definition of "income" or "net income" for the purposes of trust distributions;
  - power for the trustee to determine whether receipts are to be treated as capital or income; and
  - power for the trustee to stream capital and income receipts to particular beneficiaries.
- Ascertain whether family trust elections and interposed entity elections have been made when determining which objects will benefit.
- If the distributable income of the trust includes franked dividends, consider whether the imputation credits can be passed through to the relevant beneficiary.
- Determine the distributable income of the trust.
- Determine the taxable income of the trust.
- If there are unusual kinds of income, such as exempt income or taxable capital gains, the trustee should specifically address these kinds of income in the minutes to ensure that the appropriate beneficiaries to whom it is desired to distribute these amounts actually become entitled to the income.
- Where the distributable income of the trust includes a capital gain because the distributable income is defined to:
  - be the taxable income of the trust; or
  - include any receipts, gains, other amounts or credits that are determined by the trustee to be included in the distributable income and the trustee so determines in respect of any capital gain made,

    then the trustee may pursuant to a power in the trust deed (an amendment to include the power may be necessary) determine to which beneficiaries that part of the distributable income sourced from the capital gain is to be distributed and to which beneficiaries the other distributable income is to be distributed.
- It would be better to use percentages rather than dollar figures wherever possible (eg "50% to X and 50% to Y" rather than "$50,000 to X and $50,000 to Y" or "$50,000 to X and the balance to Y". If additional amounts were not contemplated at the time of the distribution as in *Richardson's* case and are later assessed as income, the use of percentages will ensure that:
  - beneficiaries are presently entitled to all the additional income; and
  - the beneficiaries are presently entitled to all that additional income in the same proportions as originally intended.
- If it is intended that a particular beneficiary be taxed on the whole of any such additional assessed income, the "$50,000 to X and balance to Y" expression is appropriate.

- The relevance of the issues above should never be discounted without a proper consideration of the matters involved.

¶6-185 Reassessment of assessable income

Validity of balance distribution resolutions

The use of balance provisions continues to be uncertain.

Ramsden[52] stated in respect of an amended assessment to increase the income of the trust that:

> *[71] The primary judge said (at 287):*
>
> *In the view I take of the matter, the appointment of income to the Adcock Trust not being effective, Steven Hart, being the beneficiary entitled to the "balance of the income", did not take the income ineffectively appointed to the Adcock Trust. That appointment being ineffective the settlor has specified the consequences.*
>
> *[72] We agree with this construction. "The Balance" does not include the amounts which precede "The Balance" in the resolution of 30 June 1996. "The Balance" is the income of the trust for the year ended 30 June 1996 other than the amounts which precede it in the resolution in question, whether effectively appointed or not.*

The ATO has raised during audit that the balance provision is ineffective and that the beneficiaries are taxable on the amended assessment proportionately.

The RTPWG minutes[53] record consideration being given to whether the ATO accepts the effectiveness of this form of resolution.

TR 2012/D1 and TD 2012/22 provide for distribution resolutions with a balance clause.

The TLAA No. 5 states that entitlement to an unspecified amount such as "the balance" is not sufficient to record a capital gain or franked distribution "in their character".

Allocation of amended assessments

Bamford[54] held that, where the net income under s 95 ITAA36 increases as a result of an adverse assessment but there is no consequential increase to the amount of income of the trust for s 97 ITAA36, there is no alteration of the proportionate share of income of the trust as between the beneficiaries so the additional net income is taxable in the same proportions as before the reassessment. All beneficiaries are taxed proportionately on the additional assessable income.

---

52 *FCT v Ramsden* [2005] FCAFC 39 at [71]-[72].

53 Regional Tax Practitioners Working Groups minutes, 15 February 2012, item 11.

54 *FCT v Bamford* [2010] HCA 10.

Cajkusic[55] is authority that the result may be different where the consequential increase in assessable income is also an increase in the income of the trust, for example, where income is defined as equivalent to s 95 ITAA36:

> *[18] It is quite apparent from the extract of the tribunal's reasons … that the tribunal dealt with the consequences of the disallowance of the relevant outgoings as allowable deductions on the basis that it had the same affect on the trust's distributable net income, by reference to which present entitlement is determined, as it did on the trust's section 95 "net income", that is, in the year ended 30 June 1998 it had the consequences of increasing both the net distributable income and the section 95 net income by $197,125. There may be some circumstances where such consequences would follow. For example, where a provision of the relevant instrument pursuant to which a trust estate is constituted mandates that the distributable net income of a year shall be the amount that is the section 95 "net income" of that year …, but there is no such provision in this case.*

Accordingly, where the distributable income is increased, the trustee minutes may operate to engage balance distribution clauses.

Example

Adverse assessment apportionment

The Discretionary Trust has received $100 rental income and had interest deductions of $100 denied on reassessment, increasing assessable income to $200. The Corporate Trustee had appointed all of the income of Discretionary Trust as follows, with the following reassessment consequences:

Resolution	Original distribution	Original %	Reassessed distribution	Reassessed %
The first $40 to Beneficiary A	$40.00	40%	$40.00	20%
The next $60 to Beneficiary B	$60.00	60%	$60.00	30%
The balance to Beneficiary C	$0.00	0%	$100.00	50%

If income was not defined on the reassessment, then the distributable income does not change, so that the original proportions would remain the same, the balance appointment would not be engaged and Beneficiary A and Beneficiary B would be taxable on the additional $100 assessable income 40%/60%.

If income was defined as s 95 ITAA36 net income, the distributable income of the trust would be increased from $100 to $200 automatically, the balance distribution would be engaged and the increased assessable income would be taxable to Beneficiary C.

The reassessment of income other than capital gains and franked distributions will continue to be subject to apportionment on the above basis.

However, the reassessment of capital gains and franked distributions will be taxed in accordance with Subdiv 115-C ITAA97 (capital gains) and Subdiv 207-B ITAA97 (franked distributions). If no beneficiary is specifically entitled to the reassessed capital gain or reassessed franked distribution, then the Div 6E presently entitled beneficiaries will be proportionately taxed on the amount.

55 *Cajkusic v FCT* [2006] FCAFC 164.

Where income or expenses are specifically dealt with in a particular manner, there may be no mechanism to reverse the treatment on a reassessment. Contingent minutes should be avoided as these may not create a present entitlement to distributable income.[56]

TD 2012/22 discusses the consequences of an amended assessment in respect of various forms of resolutions and trust deeds.

TD 2012/22 allocation of amended assessments

TD 2012/22 seeks to illustrate the correct treatment of some of the complexities associated with the application of the proportionate approach where there is an adverse amended assessment having regard to the use of particular styles of resolution.

TD 2012/22 accepts that:

(1) default distribution clauses in trust deeds are effective where distributable income is equated to s 95 ITAA36 net income; and

(2) balance distribution resolutions are effective where distributable income is equated to s 95 ITAA36 net income.

In summary, the examples provide the following treatments:

(1) Example 1 (entitlements expressed as a specific amount: no default clause) concerns a trust deed with an income equalisation clause but no default distribution power.

The trust resolutions appoint a fixed amount ($40,000) to Ann, Ben and Cy without a balance provision.

The additional income is taxable to the trustee because neither the fixed amount resolution nor the provisions of the trust deed create a present entitlement in a beneficiary of the additional income.

(2) Example 2 (entitlements expressed as a specific amount: default clause) concerns a trust deed with an income equalisation clause and a default distribution power.

The additional income is taxable to the beneficiaries because the provisions of the trust deed create a present entitlement in the default beneficiaries of the additional income.

(3) Example 3 (entitlements expressed as a specific amount and balance resolution) concerns a trust deed with an income equalisation clause but no default distribution power.

The trust resolutions appoint a fixed amount ($40,000) to Ann, Ben and Cy but with a balance provision to David.

The additional income is taxable to the balance beneficiary David in accordance with the *Cajkusic* approach.

(4) Example 4 (proportionate resolution) concerns trust resolutions that appointed proportionate amounts (1/3) rather than fixed amounts to beneficiaries.

The additional income is taxable to the beneficiaries in the same proportion.

56 TD 2012/22 at para 64.

(5) Example 5 (distributable income not s 95 net income) concerns a trust deed with an income recharacterisation clause where the trustee resolved distributable income to be an amount and not equated to s 95 ITAA36 net income.

The trust resolutions appoint a fixed amount ($40,000) to Ed, Fred and Greg without a balance provision.

The additional income is taxable to the beneficiaries in proportion to the income appointed at 30 June in accordance with the *Bamford* approach.

(6) Example 6 (entitlements expressed as a percentage: ineffective further resolution) concerns a trust deed with an income recharacterisation clause where the trustee resolved distributable income to be equated to s 95 ITAA36 net income.

The trust resolutions appoint distributable income equally (proportionately) between Daisy and Rose but subject to a proviso that any additional income arising from an assessment is to be distributed to Bouquet Pty Ltd.

The additional income is taxable to the beneficiaries in proportion to the income appointed at 30 June in accordance with the *Bamford* approach and the proviso is ineffective or not operational.

(7) Example 7 (entitlements expressed as a specified amount: ineffective further resolution) concerns a trust deed with an income recharacterisation clause where the trustee resolved distributable income to be equated to s 95 ITAA36 net income but no default distribution power.

The trust resolutions appoint fixed distributable income of $50,000 between Daisy and Rose but subject to a proviso that any additional income arising from an assessment is to be distributed to Bouquet Pty Ltd.

The additional income is taxable to the trustee because the fixed amount resolution and the proviso is ineffective to create a present entitlement in a beneficiary.

(8) Example 8 (income different from net income: capital gain) concerns a trust deed with an income definition that excludes capital gains.

The trust resolutions provide $30,000 (30%) to Don, $30,000 (30%) to Ed, and the balance to Fi (40%).

The capital gain not being distributable income is taxable to the beneficiaries in proportion to the distributable income under the rules before 1 July 2010 and after 1 July 2010 because there was no beneficiary specifically entitled to the capital gain.

(9) Example 9 (income different from net income: non-deductible expenses) concerns a trust deed without a definition of income that receives an unforeseen adverse assessment.

The trust resolutions provided $30,000 (30%) to Cane, $30,000 (30%) to Alex, and the balance to Russ (40%).

The additional income is taxable to the beneficiaries in proportion to the income appointed at 30 June in accordance with the *Bamford* approach because distributable income could not be defined as s 95 net income.

(10) Example 10 (income defined as s 95 net income) concerns a trust deed with an equalisation clause that receives an unforeseen adverse assessment.

The trust resolutions provided $30,000 (30%) to Cane, $30,000 (30%) to Alex, and the balance to Russ (40%).

The additional income is taxable to the balance beneficiary in accordance with the *Cajkusic* approach because the adverse assessment increased distributable income because it was equated with s 95 net income.

(11) Example 11 (adverse assessment where streaming done after 1 July 2010, specific entitlement to franked dividends) concerns a trust deed with an equalisation clause and an adverse assessment increasing other income where franked dividends were streamed to a corporate beneficiary.

The trust resolution provided 100% of franked distributions to Pecan Pty Ltd, $20,000 to Pecan Pty Ltd, and the balance to Laura of other income.

The streaming was effective for the franked distribution to be taxable to Pecan Pty Ltd and unaffected by the amendment to other income. The additional other income is taxable to the balance beneficiary of the other income in accordance with the *Cajkusic* approach because the adverse assessment increased Div 6E distributable income (excluding the franked income) because it was equated with s 95 net income.

(12) Example 12 (net income less than income of trust estate) concerns a trust deed where income is not defined and as such takes its ordinary meaning. The trustee does have a power to treat receipts as being on revenue or capital account.

The trustee made a $110,000 operating profit against which it charged general expenses of $10,000 and depreciation of $10,000. The trust income for the year was $90,000. For tax purposes, the depreciation was instead $40,000. The net income of the trust was therefore $60,000.

The trustee resolved to distribute the income of the trust to each of Gwen, Bryn and Owen in equal shares. As they were each entitled to one third of the income of the trust ($30,000), they are each assessable under s 97 on one third of the s 95 net income ($20,000).

The examples above are consistent with the approach outlined in this guide.

Form of resolutions

There are a number of styles of resolution that can be employed.

A choice is generally made between proportionate distributions or specific amount distributions. Examples include:

Alternate distributions income class
$# of or referable to [INCOME CLASS] equally to [NAME] and [NAME].
All distributable income of or referable to [INCOME CLASS] to [NAME].
All distributable income of or referable to [INCOME CLASS] equally to [NAME] and to [NAME].
All distributable income of or referable to [INCOME CLASS] as to #% to [NAME] and as to #% to [NAME].
The first $# of or referable to [INCOME CLASS] equally to [NAME] and to [NAME].
The next $# of or referable to [INCOME CLASS] as to #% to [NAME] and as to #% to [NAME].
The balance of or referable to [INCOME CLASS] to [NAME].
The balance of or referable to [INCOME CLASS] equally to [NAME] and to [NAME].
The balance of or referable to [INCOME CLASS] as to #% to [NAME] and as to #% to [NAME].

Some advisers have desired to make distributions by reference to taxable income so that any adverse assessment is not visited on the beneficiary. There has been concern that distributions by reference to the taxable amount are ineffective, because the trustee is empowered to pay, apply or set aside distributable income under the trust deed and not the taxable income.

The RTPWG minutes,[57] the minutes of the NTLG Trusts Sub-group,[58] and comments in the ruling compendium TD 2012/22EC[59] also raise the issue of whether tax adjusted distributions are effective. Broadly, the resolution distributes so much distributable income as to create a taxable result. Arguably the resolution is effective because the trustee is dealing with distributable income, not taxable income.

Also, it is important to consider whether the resolution is attempting to only address the income to be included in the beneficiary's assessable income as a result of the distribution from the particular trust, rather than the beneficiary's total assessable income.[60] Examples include:

Tax-adjusted distributions (short)

First, such amount of the distributable income (excluding franked dividends and capital gains) as bears to the total income of the trust comprising all such income, the proportion that, when the share of the net income of the trust under s 97 ITAA36 is determined, provides the amount of $416.00 to [NAME].

Then such amount of the distributable income as bears to the total income of the trust comprising all such income, the proportion that, when the share of the net income of the trust under the Tax Act is determined, provides the amount of $[NUMBER] to [NAME].

The balance of distributable income to [NAME].

57 Regional Tax Practitioners Working Groups minutes, 15 February 2012, at item 11.

58 Draft Trust Consultation Sub-group minutes, April 2012, at item 4 where it was stated that "the ATO indicated that such resolutions, appropriately worded, may have the intended effect of creating a present entitlement to income by 30 June".

59 Item 1 of TD 2012/22EC.

60 Refer to comments at item 1 and item 2 of TD 2012/22EC where the Commissioner outlines concerns with the later approach.

Chapter 7

Some important tax issues

¶7-100 Developments in the tax law relating to trusts

The taxation of discretionary trusts

The Board of Taxation presented a report to the Treasurer and the Minister for Revenue and Assistant Treasurer in November 2002, titled "Taxation of discretionary trusts".

That report made several recommendations concerning the taxation of trusts:

Recommendation 1

The Board of Taxation considers that there are no compelling arguments for broad based reform to more closely align the tax treatment of discretionary trusts and companies and that the government should retain the current flow-through treatment of distributions of non-assessable amounts by discretionary trusts.

Recommendation 2

The Board of Taxation considers that in light of the implementation of trust integrity measures over several years, concern about the use of trusts for tax planning does not of itself warrant fundamental change to the tax treatment of discretionary trusts.

Recommendation 3

The Board of Taxation recommends that the government consider options for amending the income tax law to improve the effectiveness and fairness of provisions intended to prevent individuals who are trust beneficiaries with high marginal tax rates accessing, without further tax liability, funds that have been taxed only at the company tax rate.

Recommendation 4

The Board of Taxation recommends that the Commissioner of Taxation clarify and publish his views about the deductibility of interest on borrowings used to finance non-assessable distributions to beneficiaries of discretionary trusts.

On 12 December 2002, the Treasurer announced the government's response to the recommendations of the Board of Taxation.

In respect of recommendation 3, the Treasurer announced:

> *The Government will legislate with effect from today to introduce new provisions in place of Section 109UB of the Income Tax Assessment Act 1936 dealing with distributions from trusts.*

The Act repealing s 109UB and inserting a new Subdiv EA into Div 7A ITAA36 (the *Taxation Laws Amendment* (*2004 Measures No. 1) Act 2004*) was introduced into parliament on 19 February 2004 and received royal assent on 29 June 2004. The Act gave effect to the Treasurer's announcement of 12 December 2002.

The effect of the changes is that the deemed dividend provisions in Div 7A operate in substantially the same way for trusts as they have done for companies. A brief analysis of Div 7A in respect of trusts is outlined in ¶7-115 of this guide.

The Board of Taxation's report "Taxation of discretionary trusts" described in this chapter is outlined in "Attachment E: Recent amendments to the treatment of trusts". That attachment is extracted below.

Extract of "Attachment E: Recent amendments to the treatment of trusts"

Since the early 1990s, the government has amended the law dealing with planning opportunities involving trusts a number of times. Five substantial recent amendments include the following.

Use of non-resident trusts to transfer funds offshore — Pt III, Div 6AAA ITAA36

This Division was inserted into the ITAA36 in 1991 to minimise the practice of transferring funds to non-resident trusts set up in low or no tax jurisdictions, with a locally resident trustee who generally acted in accordance with the wishes of the person establishing the trust. A common procedure was to allow income to accumulate in the trust, then to repatriate the income through a series of companies and finally, a loan to an Australian resident entity.

The Division operates to ensure that the income of certain non-resident trust estates is attributed to Australian residents and, together with the Foreign Investment Fund measures contained in Pt XI ITAA36, reduces the practice of using non-resident trusts for tax minimisation purposes.

Inappropriate utilisation of losses — Sch 2F ITAA36

This schedule was inserted into the ITAA36 in 1998 to limit the practice of trafficking in loss trusts. This practice allowed the beneficiaries of trusts who were carrying losses to sell their interest in the trust, making the loss available to the new beneficiaries to reduce the tax otherwise payable on other sources of income.

To prevent the practice, the new provisions look at whether there is a relevant change in the individuals who will benefit from any deduction for the tax losses or debt deductions compared to the individuals who may have benefited from the loss or deduction when it was actually incurred. The provisions establish a range of tests that a trust must satisfy if it is to deduct current and prior year losses and debt deductions.

Circulating distributions and tracing distributions through to the ultimate beneficiaries — Pt III, Div 6D ITAA36

This Division was inserted into the ITAA36 in 1999 to provide the Commissioner of Taxation with the information required to ensure that the assessable income of ultimate beneficiaries correctly includes any required share of the net income of a trust, and that the net assets of ultimate beneficiaries reflect the receipt of tax preferred amounts. Before this Division was enacted, all or part of the net income of a trust estate could be passed through a series of trusts with no ultimate beneficiaries assessed on that net income. This could occur either because no ultimate beneficiary existed or the ultimate beneficiary could not be identified.

Now the trustee of a closely held trust with a trustee beneficiary must disclose to the Commissioner of Taxation the identity of the ultimate beneficiaries of certain net income and tax preferred amounts of the trust. If the trustee fails to comply or if no ultimate beneficiaries exist, ultimate beneficiary tax is imposed at the highest marginal rate plus Medicare levy on the net income.

Personal services income rules — Pt 2-42 ITAA97

The tax regime for personal services income was inserted into the ITAA97 in 2000 to prevent individuals reducing their tax by alienating their personal services income to an interposed entity, such as a trust. The alienation of income in this way allowed income to be retained in the entity and either taxed at the lower rate available to the entity or diverted to associates, allowing individuals to pay a lower overall rate of tax. The use of interposed entities also created entitlement to a range of business deductions that would otherwise not be available to an individual providing the same services as an employee.

The provisions include personal services income in the assessable income of the individual whose personal efforts or skills generated the income, even if it was alienated to another entity. Deductions that may be claimed by the individual or interposed entity are restricted, so they broadly correspond to the deductions available to employees.

Revised social security means test treatment of private trusts and private companies

The government also introduced measures to ensure that, from 1 January 2002, income support recipients who hold their assets in private companies or trusts receive comparable treatment under the means test to those Centrelink customers who hold their assets directly.

As a result, in January 2001 revised means test forms were distributed to about 140,000 people with an involvement in a private trust or company. Over 5,000 recipients did not respond, forfeiting their entitlement to income support. In total, around 11,500 Centrelink customers had their payments or concession card cancelled and around 14,000 customers now receive reduced rates of income support. The measure has led to annual savings of around $100m.

Approximately 65,000 entities were identified as being associated with an individual receiving income support payments. Of these, about 23,000 were identified as discretionary trusts (with income totalling about $250m and assets totalling about $3.9b) and 37,000 were identified as small proprietary companies (with income totalling about $180m and assets totalling about $3.6b).

Public consultation

The federal government review "Australia's future tax system" chaired by Dr Ken Henry and released on 2 May 2010 made comment in relation to the taxation of trusts that further endorsed the present system in theory but called for greater clarity and a reduction in complexity. Specifically, when considering the present system of the taxation of trusts the report states:

> *In Australia, partnerships and, to a significant degree, trusts are taxed on a flow-through basis. While this remains broadly appropriate, the general trust tax rules are complex and give rise to uncertainty. Accordingly, those rules should be rewritten and updated.*

In proposing change, recommendation 36 of the report states:

> *The current trust rules should be updated and rewritten to reduce complexity and uncertainty around their application.*

While the government was slow to address this particular aspect of the report, the Assistant Treasurer and Minister for Financial Services and Superannuation in a press release of 16 December 2010 confirmed that the government would introduce amendments before 30 June 2011 so that beneficiaries can continue to use the primary production averaging and farm management deposits provisions in a loss year. He also made a commitment to update Australia's trust taxation laws and confirmed that an initial consultation paper would be released in the first part of 2011.

The press release specifically addressed the need to clarify aspects of the streaming of income with different tax characteristics and confirmed that the present system of primarily assessing beneficiaries in respect of the taxable income of trust estates rather than taxation of trusts as companies would be maintained. The press release reported as follows:

> *… As well as farmers, thousands of family businesses will enjoy more certainty as the Gillard Government today made a commitment to update Australia's trust taxation laws.*
>
> *There are also major uncertainties after Bamford, especially about the extent to which amounts derived by trustees retain their character (for example, as capital gains or franked dividends) when they flow through to beneficiaries.*
>
> *To address these issues, the Assistant Treasurer, the Hon Bill Shorten MP, today announced a public consultation process as the first step towards updating the trust income tax provisions in Division 6 of Part III of the Income Tax Assessment Act 1936 (ITAA 1936) and rewriting them into the 1997 Act.*
>
> *"In developing an initial consultation paper for release in the first part of 2011, Treasury will draw heavily on the expertise of the private sector, particularly through the established Tax Design Panel process and the Board of Taxation," said the Assistant Treasurer.*
>
> *"The options to be canvassed in public consultation will be developed within the broad policy framework currently applying to the taxation of trust income," he said.*
>
> *Any options will seek to ensure that net taxable income of a trust is assessed primarily to beneficiaries. Trustees will continue to be assessed only to the extent that amounts of net taxable income are not otherwise assessable to beneficiaries. The options will not include the taxation of trusts as companies, which would be a major departure from the current law …*

Discussion paper "Improving the taxation of trust income"

On 4 March 2011, the Assistant Treasurer and Minister for Financial Services and Superannuation, the Hon. Bill Shorten, MP, released a discussion paper titled "Improving the taxation of trust income".

The discussion paper outlined proposals to amend the tax law concerning trusts for the 2010-11 income year, with proposed amendments intended to:

- align distributable income with taxable income; and
- ensure that capital gains and franked distributions can be streamed to particular beneficiaries.

While the *Tax Laws Amendment (2011 Measures No. 5) Act 2011*, which introduced provisions regarding the streaming of capital gains and franked distributions, received royal assent on 29 June 2011, the wholesale rewrite of the trust income tax provisions was deferred for further consultation regarding the options to rectify distributable income and taxation income distinctions.

These issues are addressed in greater detail at ¶6-130 of this guide.

Modernising the taxation of trust income

On 21 November 2011, Treasury issued a consultation paper titled "Modernising the taxation of trust income – options for reform". These reforms were originally announced on 16 December 2010 following the High Court's decision in *FCT v Bamford* [2010] HCA 10.

The purpose of the consultation paper was to improve and simplify the taxation of trust income in Australia and to rewrite Div 6 ITAA36 into the ITAA97. The paper identified key issues that were said to impede the effective operation of Div 6 ITAA36 and the effective taxation of trusts. Some of the key issues that were discussed in the paper were:

- the concepts of "distributable income" and "taxable income" of a trust;
- the method for allocating taxable income of the trust to either the beneficiaries or the trustee; and
- whether trust receipts retained their character and source.

The government stated in the paper that it is intended that the taxable income of a trust will continue to be assessed primarily to beneficiaries, with trustees being assessed and liable to pay tax only to the extent that taxable income is not assessed to beneficiaries. The paper discussed three options for reform. Namely, the "patch" model; the "proportionate within class" model; and the "trustee assessment and deduction" model.

These issues are addressed in greater detail at ¶6-135 and ¶6-160 of this guide.

At the time of publication of this guide, the government's indicative timeline on the taxation of trusts reforms is:

Revised consultation timetable for trust reforms	
Release of exposure draft legislation (Div 6, fixed trusts and MITs)	Early 2013
Consultation roundtables (before close of public submissions)	Early 2013
Introduction of legislation (Div 6, fixed trusts and MITs)	Mid-2013

The reforms to the taxation of trusts provisions in Div 6 ITAA36, which were initially said to have effect from 1 July 2013, were delayed to 1 July 2014.

Since the release of the consultation paper, a discussion paper was released that outlines proposals for reforming the definition of "fixed trust" which follows the Federal Court decision in *Colonial First State Investments Ltd v FCT* [2011] FCA 16 where the strict definition of a "fixed trust" means that few trusts would satisfy that definition in s 272-65 of Sch 2F without an exercise of the Commissioner's discretion.

Treasury also released an options paper for the proposed reforms on 24 October 2012 in relation to the scope of the reforms on the trust taxation rules and how the trusts should be taxed. This paper provided an update in relation to the proposed reforms and included a discussion on the ability to stream various categories of income. In particular, the paper further discusses the intricacies of two proposed models, the "economic benefits model" (EBM) and the "proportionate assessment model" (PAM).

A summary of the two models set out in the paper is extracted below.

Current law	EBM	PAM
1. Basis for assessment		
Beneficiaries are assessed on a share of the trust's net income, based on their present entitlement to a share of the income of the trust estate. Trustees are assessed on net income that is not assessed to beneficiaries.	Beneficiaries are assessed on amounts distributed or allocated to them that represent amounts of the trust's taxable income. Trustees are assessed on amounts representing taxable income that are not distributed or allocated to beneficiaries.	Beneficiaries are assessed on a share of the trust's taxable income based on their present entitlement to a share of the trust profit or class amounts. Trustees are assessed on taxable income that is not assessed to beneficiaries.
2. Character retention and streaming		
Capital gains and franked distributions can be streamed to beneficiaries. These amounts retain their tax character when assessed to beneficiaries.	Amounts representing the trust's taxable income retain their tax character when distributed or allocated to beneficiaries, except where other parts of the tax law limit character retention. All amounts can be streamed to beneficiaries.	Classes of taxable income assessed to beneficiaries retain their tax character, except where other parts of the tax law limit character retention. All amounts can be streamed to beneficiaries.
3. Time for determining entitlements		
Trustees must determine beneficiary entitlements by 30 June, other than entitlements to capital gains, which may be determined up to 31 August.	Trustees must declare distributions and allocations to beneficiaries by 31 August. This does not mean amounts must actually be paid by that date.	Trustees must determine beneficiary entitlements by 31 August.

Despite the focus on the two models illustrated in the paper, Treasury has not ruled out adopting the alternative "patch model" that was described in the consultation paper.

Taxpayers will need to wait until the release of the exposure draft legislation to see which approach (if any) the government will adopt and how any new proposed model will ultimately operate. This is likely to occur as part of the broader tax white paper process, discussed below.

ATO focus on trust structures

Following recent compliance of trust structures, the ATO has established the Trusts Taskforce to target exploitation of trusts, mischaracterisation of transactions, and misuse of trust structures for tax avoidance or tax reduction purposes.[1] With increased funding from the federal government, the Trusts Taskforce plans to

1 Website at www.ato.gov.au/General/Trusts/In-detail/Compliance/Trusts-Taskforce.

enhance compliance and audit those businesses and individuals that promote known tax schemes and those who participate in such arrangements.

In brief, the Trusts Taskforce will be looking at arrangements including those that involve:

- excessively complex trust structures;
- trust arrangements involving persons or businesses with a previous history of non-compliance;
- the use of special purpose trusts to mischaracterise revenue activities;
- offshore transactions that involve secrecy jurisdictions;
- agreements which appear to have a non-commercial basis;
- trusts or beneficiaries which have not lodged tax returns or activity statements where they have received a substantial income; and
- redirection of tax liabilities with the effect that the tax outcomes do not reflect the economic benefits.

While the Trusts Taskforce intends to target higher risk taxpayers, taxpayers should be aware of the ATO's emphasis on the trust structures and seek independent advice or review to ensure that their arrangements are in accordance with the applicable laws.

Beneficiary disclaiming a trust entitlement

Bamford confirmed that, once the share of the distributable income of the trust to which a beneficiary is presently entitled is determined, the beneficiary will be assessed on that same proportion of the trust's taxable income.

A beneficiary is presently entitled where that beneficiary has a vested and indefeasible interest in any of the income of the trust estate (s 95A(2) ITAA36 and *Harmer v FCT* (1991) 173 CLR 264).

Present entitlement must be determined by 30 June each year.

In *Alderton and FCT* [2015] AATA 807, a trust had been established during the course of the taxpayer beneficiary's relationship with her ex-partner, who acted as the trustee of the trust. The trustee regularly deposited funds into the trust's bank account and the taxpayer accessed the funds in the account using a debit card provided to her by the trustee. After the relationship ended, the trust lodged its tax return disclosing net income as having been distributed to the taxpayer.

The AAT affirmed the Commissioner's attempt to include the amount of the distribution in the taxpayer's taxable income for the relevant income year, together with penalties. The AAT held that the taxpayer was presently entitled to the net income of the trust shown by the trust's return as having been distributed to her, stating "until disclaimer, a beneficiary's entitlement to income under a trust is operative for the purposes of s 97 of ITAA 1936 from the moment it arises notwithstanding that the beneficiary has no knowledge of it". For a disclaimer to be effective, it must constitute an absolute rejection of the gift. While the taxpayer had sufficiently evidenced a disclaimer of her interest in the trust, the disclaimer was not effective as it did not constitute an absolute rejection of the gift as the beneficiary, having had the use and benefit of the distribution, had accepted it and was no longer able to disclaim it.

Business structuring

Small businesses may be able to more easily convert to a trust structure if amendments to the tax law proposed in the exposure draft for the Tax and Superannuation Laws Amendment (2015 Measures No. 6) Bill 2015: Small business restructure rollovers (which was released by the federal Treasury on 5 November 2015) are enacted.

The proposed amendments aim to allow small businesses to defer gains and losses arising from the transfer of capital gains tax assets, depreciating assets, trading stock and revenue assets between entities as part of a restructure, with new Subdiv 328-G extending roll-over relief to transfers of assets from a company to a sole trader, partnership or trust, which occur on or after 1 July 2016, provided there has been no change in the ultimate economic ownership of the transferred assets.

Eligibility for the roll-over extends to:

(1) an entity that qualifies as a "small business entity" (being a business entity with an annual turnover which, when combined with that of its affiliated and connected entities, is less than $2m, or with a maximum net asset value which, when combined with that of its affiliated and connected entities, is less than $6m) in the income year in which the transfer takes place; and

(2) an entity that is an affiliate of, or that is connected with, a small business entity for the income year that satisfies the maximum net asset value test at the time of the transfer, and which passively holds assets that are used by the small business entity in its business.

Tax white paper process

Going forward, trust reform will now be addressed as part of the broader white paper process in relation to taxation, as discussed in the *Re:think — better tax, better Australia* tax discussion paper released by the Treasurer on 30 March 2015, which is being conducted in conjunction with the white paper on the reform of the Federation.[2]

¶7-105 The CGT event E4 problem

The problem

The distribution of non-assessable amounts (such as the small business 50% active asset reduction) triggers a CGT event to unitholders, resulting in a reduction in the cost base of their interest in the trust and, in some cases, a taxable capital gain.

The problem specific to CGT concessions

The benefit of the small business 50% active asset reduction is reduced where the non-assessable amount is distributed to unitholders.

2 Website at http://bettertax.gov.au/publications/discussion-paper.

The benefit (the 50% active asset reduction amount) is reduced by:

- *100%* where the unitholder is not entitled to either the 50% CGT discount (ie where an individual or trust has not held the units for 12 months, or the unitholder is a company) or the small business 50% active asset reduction in respect of capital gains on the units;
- *50%* where the unitholder is entitled to the 50% CGT discount but not the small business 50% active asset reduction in respect of capital gains on the units (or vice versa); or
- *25%* where the unitholder is entitled to both the 50% CGT discount and the small business 50% active asset reduction in respect of capital gains on the units.

If the net capital gain is not distributed from the trust within the year of income it was derived, the benefit will be lost through application of the gross-up rules.

Why does the CGT event happen?

The distribution of the non-assessable amount (eg the amount of the small business 50% active asset reduction) gives rise to a further CGT event (CGT event E4: capital payment for trust interest). This is because the trustee of the trust makes a payment (of the distribution) to a unitholder in respect of the unitholder's units or interest in the trust, and that payment is not included in the unitholder's assessable income. The payment will now be referred to as "the non-assessable part".

Section 104-70(6) ITAA97 provides that the cost base of the units or interest in the trust is reduced by the amount of the non-assessable part paid to the unitholder.

A capital gain will arise immediately if the non-assessable part is more than the cost base of the units or interest in the trust (s 104-70(4) ITAA97). In this event the capital gain is equal to the amount by which the non-assessable part is more than the cost base of the units or interest. Further, the cost base of those units or that interest will be reduced to nil.

Even if the payment of the non-assessable part gives rise to no further capital gain when the amount of the small business 50% active asset reduction is paid to a unitholder (eg where the cost base of the unitholder's units or interest exceed the non-assessable part distributed), the benefit of the small business 50% active asset reduction may still be effectively reduced as a result of the cost base reduction but the adverse effect of the reduced benefit is deferred until such time as the structure is wound up.

Example

Capital gain of the trust	$200,000	
Assessable capital gain	$100,000	
Non-assessable part (50% active asset reduction)	$100,000	
[Note: Example assumes that the 50% CGT discount is not available]		
Cost base of interest	$ 50,000	1
Non-assessable part (50% active asset reduction)	$100,000	2
Capital gain to unitholders	$ 50,000	
(being the amount that 2 exceeds 1)		
And cost base reduced to	Nil	

Further capital gain of $50,000 to the unitholder may be reduced by:

- the 50% CGT discount; or
- the small business 50% active asset reduction.

Why does the 50% CGT discount not cause a problem?

There is a specific exemption in the legislation for non-assessable amounts relating to the 50% CGT discount.

¶7-110 How does a beneficiary qualify for franking credits?

Introduction

Part IIIAA ITAA36 ceases to apply to events that occur on or after 1 July 2002. Part IIIAA dealt with the franking of dividends and has been largely re-enacted in Divs 200 to 218 ITAA97. However, Pt IIIAA, Div 1A ITAA36, which sets out the circumstances in which a taxpayer can qualify for a franking credit, a franking rebate or the intercorporate dividend rebate has not yet been re-enacted. Provisions addressing these issues will be introduced in further instalments of amending legislation.

Division 1A sets out a series of rules that limit when a shareholder who is paid a dividend will be entitled to a franking benefit (the benefit of the tax paid by the company on the profits distributed by way of the dividend). The rules also limit when a beneficiary is entitled to a franking benefit in relation to dividend income distributed from a trust. Only where:

- the shareholder (or beneficiary) has for a specified period born the economic risk and opportunities of holding the share (the holding period rule); and
- has not and will not transfer the economic benefit of the dividend by the making of payments (the related payments rule) to some other person,

will the shareholder (or beneficiary) be entitled to the franking benefit.

In a press release dated 27 September 2002 (the release), the Assistant Treasurer, Senator Coonan, stated that the simplified imputation system (contained in the ITAA97) indirectly relies on the provisions of Div 1A to give effect to the holding period rule and the related payments rule. The release provides that "in determining whether a taxpayer is a 'qualified person' and therefore entitled to franking benefits, [the simplified imputation system] relies on the provisions contained in Div 1A as if those provisions had continued to apply. This indirect approach will be replaced so that the relevant provisions are actually contained within the [simplified imputation system]". Accordingly, this part of the guide references the provisions of Div 1A, Pt IIIAA ITAA36 which continue to have indirect application until re-enactment.

Generally, where there is a distribution of dividend income under a discretionary trust, then unless there is a family trust election, the beneficiary will not get the franking credit benefit associated with the dividend. This is because the beneficiary has to bear the exposure to the share for the holding period in respect of which they have received the dividend, independent of the trustee's exposure, which is unlikely to happen. Where a family trust election is made, there is no requirement for a beneficiary to have an exposure to the share independent of the trustee.

In order to qualify for franking credits, a taxpayer must be a "qualified person" in relation to a dividend. Generally, in order to be a qualified person in relation to a dividend a taxpayer must satisfy two rules:

- the holding period rule; and
- the related payments rule (s 160APHO ITAA36).

The holding period rule applies in relation to shares (or interests in shares in respect of which a franked dividend has been declared) which were acquired by a taxpayer on or after 1 July 1997 (unless the taxpayer was contractually obligated to acquire the shares before 7.30 pm local time in the ACT on 13 May 1997). Special rules apply to beneficiaries of trusts (excluding widely held public share-trading trusts) that acquired shares or interests in shares after 3 pm local time in the ACT on 31 December 1997.

The related payments rule applies to arrangements entered into on or after 7.30 pm local time in the ACT on 13 May 1997.

A taxpayer may be a qualified person in relation to a dividend without satisfying the holding period rule and the related payments rule where:

- the shares or interests in shares in respect of which the dividend has been declared are held in connection with the liquidation of a company;
- the taxpayer, being an individual, satisfies the small shareholder exemption; or
- selected entities elect to have the franking credit ceilings applied.

In respect of each of the three alternatives above, it is a requirement that to satisfy the alternative, a related payment has not been made. The provisions requiring there be no related payment in respect of each of the three alternatives are as follows:

- shares issued under winding up — s 160APHQ(c) ITAA36;
- small shareholder qualified person — s 160APHT(2) ITAA36; and
- qualified person by electing franking credit ceilings — s 160APHR(3) ITAA36.

This part of the guide considers how an individual, in his or her capacity as a beneficiary of a family discretionary trust, may be a qualified person in relation to a dividend. Accordingly, for the purposes of determining whether the beneficiary is a qualified person, only the requirements of s 160APHO and the small shareholder exemption will be considered.

Special rules for dividends received through a trust

Part IIIAA, Div 1A, Subdiv B ITAA36 contains specific rules regarding the treatment of dividends received by a taxpayer as a partner in a partnership or as a beneficiary of a trust.

A beneficiary's "interest" is defined in s 160APHD to mean, in relation to shares or other property, any legal or equitable interest in those shares or property.

Although at common law the discretionary object of a discretionary trust does not have any legal or equitable interest in the trust fund, s 160APHG effectively redefines the common law position for the purposes of Div 1A.

Section 160APHG specifies the rules regarding the acquisition or disposal of shares or interests in shares by partners and beneficiaries of trusts. If the trustee of a trust acquires, holds or disposes of shares or an interest in shares, each beneficiary of the trust (including, if the trust is a discretionary trust, a potential beneficiary) is taken to acquire, hold or dispose of an interest in the shares (s 160APHG(3)). Similarly, where a trust estate includes shares or an interest in shares, a taxpayer who becomes a beneficiary of the trust (including, if the trust is a discretionary trust, a potential beneficiary) will be taken to acquire an interest in the shares. If the taxpayer ceases to be a beneficiary of the trust, the taxpayer would be taken to have disposed of the interest in the shares (s 160APHG(4)).

Where a beneficiary holds an interest in shares under a trust and the shares or the interest in the shares are distributed to the beneficiary in satisfaction of the beneficiary's interest in the trust, the beneficiary is taken to have held the shares or interest from the time the beneficiary acquired the interest in the trust (s 160APHH(3)).

How to determine a beneficiary's interest in shares

Section 160APHL contains the procedure for determining a beneficiary's interest in shares or interests in shares held by a trust for the purposes of determining whether the beneficiary is a qualified person in relation to a dividend.

Where:

- a trustee of a trust (other than a widely held trust) holds a share or an interest in a share which results in an amount being included in the assessable income of the trust;
- the whole or part of the amount included in the assessable income of the trust (the dividend income) is a dividend or attributable to a dividend received through one or more interposed entities; and
- an amount of the net income of the trust (the trust amount) has been distributed to a beneficiary which is wholly or partly attributable to the dividend income,

the beneficiary's interest in the share for the purposes of determining whether the beneficiary is a qualified person is determined in accordance with the provisions of s 160APHL(5).

Section 160APHL(5) contains the following formula:

$$\text{Value of share or interest in share held by the trust} \times \frac{\text{Beneficiary's share of dividend income}}{\text{Dividend income amount}}$$

The formula provides that the beneficiary's interest in a share or interest is that beneficiary's share in the income derived by the trust from that share, expressed as a proportion of the total dividend income derived by the trust from that share or interest.

Example

James is a beneficiary of the Kavanagh Discretionary Trust (the trust). The trust holds 100 shares in Investco Pty Ltd (the company). The shares are valued at $2 each. The company declares and pays a dividend of $200 to the trust. The trustee of the trust distributes half of the dividend income ($100) to James. James' interest in each share is $1, calculated as follows:

$$\$2 \times \frac{\$100}{\$200} = \$1$$

Significantly, the position of a trustee in relation to the trust's share or interest in a share is taken to be a position of the beneficiary, to the extent to which the position relates to the beneficiary's interest in the relevant share. If the trustee has a position in relation to two or more shares or interests in shares, the trustee's position is taken to constitute a separate position in relation to each of the shares or interests (s 160APHL(8)). Therefore, a beneficiary will only be a qualified person in relation to the dividend if the trustee of the trust is a qualified person. *If the trustee is not a qualified person then the beneficiary will not be entitled to receive a franking credit through the trust.*

The requirements of s 160APHO

Where a related payment is not made

A related payment by a taxpayer or an associate of a taxpayer is a payment that transfers the economic benefit of a dividend to another person. Section 160APHN(3) includes some specific examples of related payments but is not exhaustive. Section 160APHNA excludes certain payments from the definition of related payment.

A beneficiary is a qualified person in relation to a dividend if, where neither the beneficiary nor an associate of the beneficiary has made, is under an obligation to make, or is likely to make a related payment in respect of the dividend, the beneficiary has held the interest for a continuous period (not counting the day(s) on which the beneficiary acquired or disposed of the interest) of not less than:

- 45 days — if the shares are not preference shares; or
- 90 days — if the shares are preference shares,

during the (primary qualification) period commencing on the day after the beneficiary acquired the shares or interest and ending:

- on the 45th day after the day on which the shares or interest became ex dividend — if the shares are not preference shares; or
- the 90th day after the day on which the shares or interest became ex dividend — if the shares are preference shares.

A share or an interest in a share becomes ex dividend on the day after the last day on which the acquisition of the share or interest will entitle the acquirer to receive a dividend (s 160APHE(1)). Paragraph 4.95 of the explanatory memorandum to the *Taxation Laws Amendment Act (No. 2) 1999* provides:

> *… a share or interest becomes ex dividend on the day after the last day on which the shares or interest in shares can be acquired by a taxpayer so as to become entitled to the dividend … For example, if a company declares a dividend on 1 June, to be paid on 30 June, and the dividend can be paid to a shareholder who held shares up to 25 June (but no later), then the ex dividend day is 26 June.*

Where a related payment is not made and the holding period rule is satisfied in relation to a dividend received by a beneficiary in respect of an interest, the holding period rule will be satisfied in respect of any subsequent dividends. That is, the holding period requirement is a once and for all test.

Where a related payment is made

Where a beneficiary or an associate has made, is under an obligation to make or is likely to make a related payment in respect of a dividend, the beneficiary must hold the interest in the shares for a continuous period (not counting the day on which the beneficiary acquired or disposed of the interest) of not less than:

- 45 days — if the shares are not preference shares; or
- 90 days — if the shares are preference shares,

during the (secondary qualification) period commencing on the 45th day before the day on which the interest in shares became ex dividend and ending on the 45th day after the day on which the interest in shares became ex dividend.

This holding period requirement must be satisfied in respect of each dividend received on the share.

Calculating the days

When calculating the number of days for which a taxpayer continuously held the shares or interest, any day(s) on which the taxpayer acquired and/or disposed of the share or interest and the days on which the taxpayer has materially diminished risks of loss or opportunities for gain in respect of the shares or interest are not taken into account. However, the exclusion of those days does not constitute a break in the continuity period for which the taxpayer held the shares or interest (s 160APHO(3)).

Materially diminished risks of loss or opportunities for gain

Regulations may prescribe when a taxpayer is taken to have materially diminished risks of loss or opportunities for gain. However, where there are no such regulations, a taxpayer is taken to have materially diminished risks of loss or opportunities for gain on a particular day in respect of a share or interest in shares held by the taxpayer if the taxpayer's net position on that day in relation to the shares or interest has less than 30% of the risks and opportunities (s 160APHM(2)). A taxpayer's net financial position is determined using the financial concept known as delta, which measures the change in the price of options or other derivatives in relation to a change in the price of the underlying asset (s 160APHM(3)). The concept of deltas introduces much complexity because there is no way of calculating it and small taxpayers generally would not know what the relevant delta is.

Trusts in respect of which a family trust election has been made

Under s 160APHL(5) a taxpayer's interest in a share is worked out using the formula discussed above. Section 160APHL(7) provides that the taxpayer's interest in the shares worked out under the formula is a long position with a delta of +1 in relation to itself. A long position in relation to shares or an interest in shares is a position that has a positive delta in relation to the shares or interest. Shares or interests in shares are treated as a long position with a delta of +1 in relation to themselves (s 160APHJ(4)). Therefore, when determining whether a beneficiary has materially diminished risks of loss or opportunities for gain for the purposes of calculating the number of days the beneficiary has held the relevant interest in shares, a delta associated with any change in the interest (such as the grant of an option) must be considered in relation to the +1 delta.

Section 160APHL(10) specifies an additional position of a taxpayer where the share or interest in a share is held by a trust in respect of which a family trust election has not been made for the purposes of Sch 2F ITAA36. Where the trust is not a family trust (for the purposes of Sch 2F) and is not a trust merely because it is a deceased estate administered by an executor or administrator, and the beneficiary's interest in the relevant share is not an employee share scheme security, the beneficiary is taken to have, in addition to any other long or short position in relation to the relevant interest:

- a short position equal to the beneficiary's long position; and
- a long position equal to so much of the beneficiary's interest in the trust holding as is a fixed interest.

Therefore, a beneficiary of a discretionary trust in respect of which a family trust election has not been made, will have in respect of its interest in shares a long position of +1 and a short position of -1. The beneficiary's long position is effectively cancelled and because the beneficiary does not have a fixed interest in the interest, it will not have an additional long position. *Accordingly, a beneficiary of a discretionary trust (which is not a family trust) which does not have a fixed interest and has no other long positions in relation to its interest in shares, will have a net position of zero (ie less than 30%) and consequently materially diminished risks of loss and opportunities for gain.* None of the days on which the beneficiary has materially diminished risks of loss or opportunities for gain will be taken into account when calculating the days for the purposes of the holding period rule.

> Accordingly, a beneficiary of a discretionary trust which is not a family trust would generally not satisfy the holding period rule.

In order to avoid failing the holding period rule, a family trust election could be made in respect of the relevant trust through which the shares or interests in shares are held. However, it should be noted that where the trustee of a trust in respect of which a family trust election has been made, makes a distribution of or confers a present entitlement to income or capital to a person other than the test individual or a member of the test individual's family group, the trustee (or in the case of a corporate trustee, the directors) would be liable to pay family trust distribution tax on that amount at the rate of 45% plus Medicare levy. The test individual is the person specified in the election and the test individual's family group includes family members and certain family owned or controlled entities of the test individual.

Case study

The Acme Discretionary Trust (the trust) acquired 200 non-preference shares in a company on 1 July 2005. On 1 February 2006, Acme Investments Pty Ltd (the company) declared a fully franked dividend of $130 to be paid on 28 February to shareholders who held shares in the company up until 25 February. The trust was at all times the sole shareholder in the company.

On 30 June 2006, the trust distributed an amount of the trust's net income of $230 to Susan Smith and $100 to David Jones in their capacities as beneficiaries of the trust. The $230 distributed to Susan included dividend income of $130 and other trust income of $100. The $100 distributed to David did not include dividend income. Both Susan and David included their respective trust amounts in their assessable income for the income year ended 30 June 2006.

Is Susan a qualified person in respect to the dividend of $130 paid by the company?

Susan satisfies the related payments rule because she did not transfer the economic benefit of the dividend income to another entity.

In order to satisfy the holding period rule, Susan must hold the interest in the shares for a continuous period of 45 days through the primary qualification period. The primary qualification period commences on the day after the day on which she acquired the interest in the shares (being 2 July 2005) and ends on the 45th day after the day on which the interest becomes ex dividend. The interest becomes ex dividend on 26 February 2006, so the primary qualification period ends on 12 April 2006. The trustee of the trust has held the shares throughout the primary qualification period and Susan, as a discretionary object of the trust, will also satisfy the holding period rule in relation to her interest in the shares — provided she does not have materially diminished risks of loss or opportunities for gain in relation to the interest.

Susan has a long position in relation to the interest in the shares and the position has a positive delta of +1. However, under s 160APHL(10), Susan has the additional position of a short position equal to her long position. Therefore, Susan has a long position of +1 and a short position of –1. As Susan does not have a fixed interest in the trust and no other long positions, she has a net position of zero and materially diminished risks of loss or opportunities for gain. Accordingly, Susan does not satisfy the holding period rule at any time during the primary qualification period.

However, if a *family trust election* had been made in relation to the trust, Susan would have a long position of +1 throughout the primary qualification period and would not have materially diminished risks of loss or opportunities for gain on any day during the primary qualification period. Because Susan is taken to have acquired her interest in the shares on the day the trustee acquired the shares, she would satisfy the holding period rule.

Individuals qualified by having a franking rebate ceiling applied

Section 160APHT provides that a taxpayer is a qualified person in relation to all dividends paid during an income year on shares the taxpayer held (or in which the taxpayer held an interest) if the taxpayer is an individual and the total amount of the rebates to which the taxpayer would be entitled under ss 160AQU, 160AQX and 160AQZ in respect of the income year does not exceed $5,000 (as long as the taxpayer was a qualified person in relation to each of the dividends).

The taxpayer is not a qualified person under this definition if the taxpayer or an associate of the taxpayer has made, is under an obligation to make or is likely to make a related payment in respect of the dividend.

Accordingly, beneficiaries who are natural persons and have a total franking rebate entitlement for the relevant income year not exceeding $5,000 will be qualified persons in relation to all dividends paid during an income year on shares (or interests in shares) held by the beneficiaries. The exemption automatically applies to all individuals with franking credits of $5,000 or less, derived from all sources. The $5,000 ceiling applies to the total amount of franking rebates received by the beneficiaries, rather than the trust.

This exemption applies in respect of the income year ended 30 June 2000 and subsequent years. For prior years, an election had to be made and in order for the franking rebates to be accessed in full they could not exceed $2,000. A sliding scale applied up to $2,500, above which no rebates would have been allowed.

Simplified imputation system

Subdivision 207-B ITAA97 deals with the effect of receiving a franked distribution through certain partnerships and trusts.

Subject to Subdiv 207-F ITAA97 (specifically s 207-150), where a franked distribution is made to a trustee of a trust and the distribution flows indirectly to a beneficiary or trustee of the trust, for the purposes of determining the net income of the trust under s 95 ITAA36, the assessable income of the trustee includes an amount equal to the franking credit on the distribution. The franked distribution to the trust is then treated as flowing indirectly to the beneficiary of the trust.

Each beneficiary's share of the franking credit from the distribution is included in that beneficiary's assessable income. The beneficiary is then given a tax offset equal to the share of the franking credit (provided the beneficiary is not a partnership or trust). Where the trustee is primarily liable for tax on the distribution, the trustee obtains the tax offset.

Subdivision 207-F sets out cases in which the gross-up and tax offset rules in Subdiv 207-A and Subdiv 207-B do not apply because the imputation system has been manipulated in a prohibited manner. The provisions of the subdivision were amended by chapter 10 of the *Tax Laws Amendment (2004 Measures No. 2) Act 2004*. The changes generally apply from 1 July 2002 and were intended to merely clarify the law, not to change its application (para 10.7 of the explanatory memorandum to the *Tax Laws Amendment* (*2004 Measures No. 2) Act 2004*).

Broadly, under the new s 207-150 ITAA97, a beneficiary's entitlement to a tax offset is denied because (amongst other reasons) the beneficiary is not a qualified person for the purposes of Div 1A.

Where a beneficiary is not a qualified person and it receives a distribution of trust net income which includes a franked dividend amount, the beneficiary is entitled to a deduction under s 207-150(3) ITAA97 of an amount equal to the lesser of:

- its share of the net income of the trust; and
- the amount of its share of the franking credit on the dividend.

Further, the beneficiary is denied a tax offset and the franked dividend does not flow through to a lower tier entity. The deduction effectively removes the grossing up of the dividend amount that occurred when determining the trust's assessable income.

What if the trust has losses?

Under s 160AQY ITAA36, a trustee will only be entitled to a franking rebate where the trustee is liable to be assessed (under either s 98, 99 or 99A) on a trust amount and there is a flow-on franking amount in relation to the trust amount.

The term "trust amount" is defined in s 160APA to broadly mean a share of the net income of the trust estate for which either the beneficiary is liable for tax under ss 97, 98A or 100 or the trustee is liable for tax under ss 98, 99 or 99A. Paragraph (a) of the definition of the term "flow-on franking amount in relation to a trust amount" means so much of the trust amount that is attributable to a franked dividend included in the assessable income of the trust.

Therefore, where the trustee is liable to be assessed on a trust amount which includes a franked dividend, the trustee will be entitled to a rebate equal to the "potential rebate amount" in respect of the trust amount. Pursuant to para (a), in relation to a trust amount attributable to a franked dividend included in the assessable income of the trust, the "potential rebate amount" is determined in accordance with the following formula:

$$\text{Amount included in assessable income of trust under s 160AQT} \times \frac{\text{Number of dollars in flow-on franking amount in relation to the current trust amount}}{\text{Number of dollars in so much of net income as is attributable to the franked dividend}}$$

Similarly, a beneficiary will only be entitled to a rebate under s 160AQX where a "trust amount" (ie an amount of the trust's net income) is included in the beneficiary's assessable income and there is a flow-on franking amount in respect of the trust amount. The amount of the rebate will be determined in accordance with the above formula.

Therefore, the entitlement to the rebate under both s 160AQY and s 160AQX only arises where the trust has an amount of net income for the income year. A net income of $1.00 would be sufficient for this purpose.

The Commissioner has confirmed that where a discretionary trust has a nil net income or net loss it will not be entitled to a refund of excess imputation credits under Div 67 ITAA97 because:

> *Subsection 67-25(1) of the ITAA 97 makes it clear that trustees entitled to a franking credit under section 160AQY of ITAA 36 can only receive a refund of any excess imputation credits if they are liable to be assessed under section 98 or 99 of the ITAA 36. In the case of a discretionary trust with no net income or a net loss there is no liability to such an assessment.*

Further information on this issue is provided in ID 2002/1070 and ID 2002/1071.

Therefore, in cases where the trust has no distributable income, any excess imputation credits will be lost. The rules relating to the carry-forward of excess tax offsets contained in Div 65 ITAA97 do not apply in relation to the imputation rebate and Pt IIIAA ITAA36 (dealing with the franking of dividends) does not specifically provide excess imputation credits to be carried forward to later income years.

¶7-115 Division 7A and trusts

The deemed dividend provisions in Div 7A ITAA36 are currently the subject of significant changes. The changes are to both the legislative provisions of Div 7A and also the manner in which the original provisions have been and will be interpreted and administered by the ATO.

In this paragraph we will outline:

- the operation of the current provisions of Div 7A in relation to trusts;
- the proposed amendments to the legislative regime insofar as those amendments relate to trusts; and
- the implications of TR 2010/3, PS LA 2010/4 and TD 2015/20.

Operation of the provisions prior to 1 July 2009

The *Tax Laws Amendment (2004 Measures No. 1) Act 2004* (the Act) repealed Div 7A, s 109UB ITAA36 and inserted a new Subdiv EA. The Act gave effect to the Treasurer's announcement of 12 December 2002 described in ¶7-100 of this guide.

The effect of the amendments is that the deemed dividend provisions in Div 7A ITAA36 operate in substantially the same way for trusts as they have done for companies.

The key sections introduced into Div 7A are:

- s 109XA which describes the application to payments, loans and debts forgiven;
- s 109XB which describes how the amounts are included in assessable income; and
- s 109XC which describes the modified operation of the original Div 7A provisions.

Basic elements

There are three basic elements that must exist for the provisions in Div 7A to apply. These are:

(1) A private company has an entitlement to net income of a trust estate that has not been paid (the unpaid entitlement).

(2) The trustee of the trust:

  (a) makes a loan;

  (b) makes a payment in discharge of a present entitlement either wholly or partly attributable to an amount that is an unrealised and unassessed gain; or

  (c) forgives a debt.

  These are collectively referred to as "transactions".

(3) The transactions are with a shareholder or associate of a shareholder of the company that has an unpaid entitlement.

Timing of the unpaid entitlement

Where the transaction takes place between 12 December 2002 and 18 February 2004 (inclusive), then the unpaid entitlement of the company must exist at the time of the transaction for the transaction to give rise to a deemed dividend.

Where the transaction takes place on or after 19 February 2004, the transaction will give rise to a deemed dividend if there is an unpaid entitlement in favour of the company either before the time of the transaction or after the transaction at any time up to the earlier of:

- the due date for the lodgment of the income tax return for the trust for the year of income in which the transaction took place; or
- the date of lodgment of the income tax return for the trust for the year of income in which the transaction took place.

It follows that after 19 February 2004, it does not matter whether the company has an unpaid entitlement at the time of the transaction. What is important is whether the company has an unpaid entitlement the earlier of the times set out above.

Who are shareholders and associates?

The meaning of shareholders for the purposes of Div 7A not only includes an entity that actually holds shares in the company but also includes an equity holder under the debt/equity rules.

The meaning of associate is contained in s 318 ITAA36.

Which payments are caught?

The provisions only apply to payments to the extent they discharge or reduce a present entitlement of the shareholder to an amount that is an unrealised capital or income gain that is not included in the assessable income of the trust in a previous income year, the income year of the transaction or the income year following the transaction.

Section 109C(3) ITAA36 provides that a payment can be:

- a payment or credit entitlement that it is to the entity, on behalf of the entity or for the benefit of the entity; and
- a transfer of property to the entity.

The prerequisite of the unrealised gain means that amounts paid from asset revaluation reserves will be caught by Div 7A. Further examples of unrealised gains include:

- pre-CGT property transferred in satisfaction of an unpaid entitlement to the extent of any unrealised pre-CGT gain to which the value of the property transferred was attributable;
- accrued interest;
- increases in work in progress; and
- increases in the market value of trading stock.

Which loans are caught?

A loan to a shareholder or associate will be caught unless it is made on "commercial" terms as set out in s 109N ITAA36. The agreement made in accordance with s 109N must be entered into before the earlier of the due date for lodgment and the date of lodgment of the trust's tax return for the year of income in which the loan is made.

Section 109D(3) ITAA36 defines loan to include:

- an advance of money;
- a provision of credit or any other form of financial accommodation;
- a payment of an amount for, on account of, on behalf of or at the request of, an entity, if there is an express or implied obligation to repay the amount; and
- a transaction (whatever its terms or form) which in substance effects a loan of money.

The *Tax Laws Amendments (2007 Measures No. 3) Act 2007*, which received royal assent on 21 June 2007, introduced a new provision which relates to the timing of a conversion of a payment by a private company to an entity to a loan. Section 109D(4A) ITAA36 provides that where a private company makes a payment to an entity during an income year and that payment is converted to a loan prior to the company's lodgment day for the relevant year of income, that payment and conversion are treated for the purposes of Div 7A as a loan which was made at the date of the payment.

When is a debt forgiven?

The Div 7A provisions apply where all or part of a debt owed to a trustee by a shareholder or an associate is forgiven.

Section 109F ITAA36 provides that a debt is forgiven when:

- the amount would be forgiven under Sch 2C s 245-35 (except s 245-35(4)) ITAA36, assuming that the amount was a commercial debt for the purposes of Sch 2C Div 245.

- if a reasonable person would conclude (having regard to all the circumstances) that the private company will not insist on the entity paying the amount or rely on the entity's obligation to pay the amount. (The debt is forgiven when a reasonable person would first reach that conclusion.)
- the debt is "parked" by transfer or assignment to an associate.

When will the rules not apply?

Division 7A will not apply to a transaction effected by a trust if a company does not have an unpaid entitlement in the trust by the lodgment date.

If the trust enters into a transaction with a company and the company has not effected a transaction with a target entity, Div 7A will not apply.

Payments that are not attributable to an unrealised gain will not be caught by Div 7A.

Loans that are repaid in full by the lodgment date or alternatively are made on commercial terms as set out in s 109N ITAA36 will not fall within the provisions of Div 7A.

What are the consequences of Div 7A applying?

For the purposes of applying Div 7A to trusts, the trust is treated as a notional company.

An unfranked dividend equal to the amount involved (calculated under s 109XA(4)) is included in the shareholder or associate's income. The amount involved is the lesser of:

- the amount actually involved in the transaction (ie the amount of the payment, loan or debt forgiven); and
- the amount of the unpaid entitlement less any previous amounts in relation to the unpaid entitlement that have arisen either because of the operation of s 109UB or Div 7A.

The amount of the unfranked dividend is limited by an amount defined in Div 7A as the "distributable surplus" of the private company which has the present entitlement in the trust.

The provisions also provide for a debit to the franking account of the company, which is deemed to make the unfranked dividend. Under the now repealed provisions, where trusts were involved in the transaction it was still the company that had the unpaid entitlement that was deemed to make the unfranked dividend and who suffered the debit to its franking account. Under the new Subdiv EA provisions the trust involved in the transaction is treated as a notional company for the purpose of being deemed to have made an unfranked dividend to the shareholder or associate. However, the provisions also have effect that it is the trust as the notional company that is deemed to have a debit to its franking account. As the trust does not have a franking account the debit to the franking account will not arise where the trust is treated as a notional company.

The *Tax Laws Amendments (2007 Measures No. 3) Act 2007* introduced a new discretionary power which is able to be exercised by the Commissioner to provide relief in circumstances of Div 7A applying as a result of an honest mistake or an inadvertent omission (s 109RB ITAA36). PS LA 2007/20 has been issued which provides guidance as to when the Commissioner's discretion under s 109RB ITAA36 may be exercised.

PS LA 2007/20 also outlines the Commissioner's approach for the exercise of the discretion in respect of the 2001-02 to 2006-07 income years where specific corrective action has been taken on or before 30 June 2008.

Amendments effective from 1 July 2009

In a media release dated 12 May 2009, the Assistant Treasurer and the Minister for Competition Policy and Corporate Law announced proposed new measures aimed at improving the integrity of the tax system and protecting Commonwealth revenues. One of these measures included the proposal to extend the operation of the non-commercial loan rules in Div 7A.

On 4 January 2010, the Assistant Treasurer released exposure draft legislation and explanatory material on those changes to tighten the non-commercial loan rules. This followed an earlier Treasury consultation paper headed "Improving fairness and integrity in the tax system — tightening the non-commercial loan rules in Div 7A of the Income Tax Assessment Act 1936" released on 5 June 2009.

Following the above, the *Tax Laws Amendment (2010 Measures No. 2) Act 2010* which introduced a number of changes extending and clarifying the scope of Div 7A for trusts received royal assent on 28 June 2010. One of the significant amendments to Div 7A in so far as it relates to trust was the introduction of a new Subdivision EB by Pt 1 of the *Tax Laws Amendment (2010 Measures No. 2) Act 2010* which has significantly extended the application of Div 7A to trusts, with the operation of Div 7A now extending to what is often referred to as the "double trust" structure.

The new Subdiv EB of Div 7A operates such that certain arrangements involving double trust structures, multiple trust structures or interposed entities, be deemed to fall within the provisions of Subdiv EA such that the operation of Div 7A is triggered.

The amendments to Div 7A introduced by the *Tax Laws Amendment (2010 Measures No. 2) Act 2010*, in so far as they relate to Div 7A and trusts, have effect from 29 June 2010, being the day after the *Tax Laws Amendment (2010 Measures No. 2) Act 2010* received royal assent. However, pursuant to s 35 of the *Tax Laws Amendment (2010 Measures No. 2) Act 2010* the provisions apply to loans, payments and debts forgiven on or after 1 July 2009. It is therefore fundamental that practitioners dealing with structures involving trusts understand the implications of the amendments.

Sections 109XF and 109XG

Sections 109XF and 109XG relate specifically to payments or loans through interposed entities. They operate to deem the trustee of a trust to have made a loan or payment for the purposes of Div 7A to a shareholder or associate of a shareholder of a private company (referred to as the shareholder) within the provisions of Subdiv EA (s 109XA) if:

- the trustee has made a payment or loan to another entity, being the entity that is interposed between the trustee and the shareholder; and
- a reasonable person would conclude, having regarding to all the circumstances, that the trustee made the payment or loan mainly as part of an arrangement involving a loan to the shareholder; and
- either:

- the interposed entity makes a payment or loan to the shareholder; or
- another entity interposed between the trustee and the shareholder makes a payment or loan to the shareholder.

The operation of both ss 109XF (payments) and 109XG (loans) will operate regardless of whether:

- the interposed entity made the payment to the shareholder before, after or at the same time as the interposed entity received the loan or payment from the trustee; or
- the interposed entity paid the shareholder the same amount as the trustee paid the interposed entity.

In respect of the timing of the operation of ss 109XF and 109XG, s 109XH(4) provides that the trustee is taken to have made the payment/loan at the time the interposed entity made the loan to the target shareholder.

As to the amount of the payment or loan, and therefore the amount of the unfranked dividend, s 109XH provides that this is to be determined at the discretion of the Commissioner. Section 109XH(2) sets out the matters that the Commissioner must take into account when determining the amount of the payment or loan.

Section 109XI

In addition to the introduction of new ss 109XF and 109XG, new s 109XI was also introduced by the *Tax Laws Amendment (2010 Measures No. 2) Act 2010*. Section 109XI operates to ensure that in addition to payments or loans to interposed entities being captured, unpaid present entitlements as between trusts in a multiple trust structures are captured.

Section 109XI operates to deem a company to be entitled to an amount of the net income of a trust estate (referred to as the target trust) for the purposes of s 109XA(1)(c), 2(b) and 3(b) if:

- the company is or becomes presently entitled to an amount of the net income of another trust estate, that is effectively interposed between the target trust and the company; and
- a reasonable person who conclude, having regard to the all the circumstances, that the company is entitled solely or mainly as part of an arrangement involving an entitlement to an amount from the target trust; and
- either:
    - the first interposed trust is or becomes presently entitled to an amount of the net income of the target trust; or
    - another trust interposed between the target trust and the company is or becomes presently entitled to an amount of the net income of the target trust.

Similar to ss 109XF and 109XG, s 109XI(2) provides that these provisions apply regardless of whether:

- the company became or becomes entitled to the amount of the net income of the interposed trust before, after or at the same time as the interposed trust became entitled to an amount of the net income of the target trust; or
- the company became presently entitled to the same amount as the amount to which the interposed trust is entitled.

Pursuant to s 109XI(4), the Commissioner is granted the power to determine the amount to which the company is to be taken to be entitled to from the net income of the target trust. Similar to the provisions in relation to ss 109XF and 109XG, in exercising his power the Commissioner must take into account:

- the amount the company is entitled to of the net income of the interposed trust; and
- how much of that amount the Commissioner believes represented consideration payable to the company by the target trust or the interposed trust(s) for anything (provided that consideration payable equals that for similar arm's length transactions).

In addition, s 109XI(5) provides that for the purposes of determining the amount of the entitlement of the company in the net income of the target trust, the amount of the entitlement of the company in the target trust must not exceed the entitlement of the interposed trust to an amount of the net income of the target trust.

Timing of the deemed unpaid present entitlement of the beneficiary company in the target trust also needs to be considered. Section 109XI(7) provides that the company will be taken to have the unpaid present entitlement in the target trust at the time the company is or becomes entitled to an amount of the net income of the interposed trust.

TR 2010/3

TR 2009/D8 was released on 16 December 2009 and subsequently finalised in the form of TR 2010/3 which was released by the ATO on 2 June 2010. In addition to TR 2010/3, the ATO released a ruling compendium.

TR 2010/3 sets out the Commissioner's opinion as to the meaning of financial accommodation for the purposes the definition of loan in s 109D(3) ITAA36, and in particular, whether an unpaid present entitlement to an amount of the net income of a trust by a company amounts to the provision of financial accommodation by the company such that the operation of Div 7A may be triggered.

Controversially, the ruling refers to two types of arrangements which may be considered to be loans falling within the provisions of Div 7A. The first is what is referred to in the ruling as "loans within the ordinary meaning" (referred to as section 2 loans) and the second being referred to as "Division 7A loans within the extended meaning" (referred to as section 3 loans).

Loans within the ordinary meaning (section 2 loans)

Paragraph 7 of the ruling acknowledges that a subsisting unpaid present entitlement is not itself an ordinary loan. However, the ruling specifies the Commissioner's opinion that there are situations in which an unpaid present entitlement will be treated as having been satisfied and loaned back to the trustee, such that the unpaid present entitlement is replaced with an ordinary loan from a private company to the trustee of a trust, potentially resulting in the application of Div 7A. These are referred to as "section 2 loans".

In relation to the ways in which an ordinary loan may be created, the ruling provides in paras 9, 10, 11 and 12:

> 9. *A private company makes an ordinary loan to the trustee of a trust if it provides moneys to the trustee pursuant to an agreement under which the trustee borrows the money on behalf of the trust and the private company lends the moneys to the trustee of the trust. Such a loan from the private company can be effected by an agreed set-off in satisfaction of the trustee's obligation to pay the private company its trust entitlement, rather than as a cash transaction.*

10. *The agreement between the private company beneficiary and the trustee may be an implied agreement. For example, if the private company has knowledge that the trustee has treated its [unpaid present entitlement] as having been satisfied and a corresponding amount borrowed back (as evidence, for example, by crediting a loan account in the name of the private company beneficiary) and the private company acquiesces to that treatment, it will be inferred that it has consented to that loan being made.*

11. *In the absence of sufficient evidence to the contrary, where the trust and private company beneficiary form part of the same family group, the Commissioner takes the view that the private company has knowledge of the trustee crediting a loan account in its name.*

12. *However, if a private company has acted inconsistently with treating the amount as having been loaned to the trust, it is not taken to have acquiesced to any treatment by the trustee of the amount as a relevant loan.*

In addition to the creation of an ordinary loan for the purposes of Div 7A by way of acquiescence, the ruling at para 13 makes it clear that the amount may also be a loan where the trustee is provided with the power in the trust deed to apply the appointment of income to the company by crediting a loan account in the company's name. However, para 15 further provides that a loan for the purposes of Div 7A cannot arise in this manner if the trustee is not provided with such a power to convert the unpaid present entitlement to a loan.

Therefore, there are, in effect, three circumstances in which a company may be taken to have agreed to a set off resulting in, or otherwise the provision of an ordinary loan to the trustee of a trust. These being:

- By agreement, whether express or implied.

  The case of *Re East Finchley Pty Ltd v FCT* [1989] FCA 481 is referred to by the Commissioner as an example of agreement by beneficiaries to set off an unpaid present entitlement resulting in the creation of a loan. When determining whether there is agreement to create a loan within the ordinary meaning, the conduct of both the trustee and the beneficiaries will be paramount.

- Agreement by the acquiescence of the company where it has full knowledge of the trustee's actions.

  If a beneficiary company has knowledge that the trustee of the trust has treated an unpaid present entitlement as a loan from the company, the beneficiary company may by its acquiescence have authorised the trustee's actions. Further, when determining the knowledge of the beneficiary company, it is a relevant consideration that the trustee and the beneficiary company are within the same family group (TR 2010/3 para 64).

- Pursuant to the trust deed. The provisions of the trust deed of a trust need to be reviewed carefully to determine the treatment of an appointment of income and the powers of the trustee in dealing with an unpaid present entitlement.

It is therefore essential that, in addition to reviewing the trust deed of the trust, the conduct of the parties is considered. However, what conduct will be seen as having acted inconsistently with the treatment of the unpaid present entitlement as a loan, as referred to in para 12, is not considered in detail by TR 2010/3.

The Commissioner in the ruling makes it clear that whether there is a loan within the ordinary meaning will ultimately be a question of fact. Indicators include:

- The treatment of the unpaid present entitlement in the accounts of the trust. For example, if it is credited to a loan account in the name of the company beneficiary this may be evidence of an agreement to treat the amount as a loan or alternatively result in acquiescence by the company such that the loan is authorised.
- The treatment of the unpaid present entitlement in the accounts of the company. Again, if the company beneficiary has consistently treated the amount as an unpaid present entitlement in its accounts, this may be evidence that the company has not agreed to the treatment of the unpaid present entitlement as being satisfied and replaced by a loan.

The provisions of TR 2010/3 in so far as it relates to a loan "within the ordinary meaning" has effect both before and after the date of the release of the ruling. This is on the basis of the view of the Commissioner that the provisions of TR 2010/3 regarding section 2 loans are not new nor are they inconsistent with any prior statements or publications of the Commissioner.

Loans within the extended meaning (section 3 loans)

TR 2010/3 sets out the circumstances in which a private company beneficiary will be taken to have provided financial accommodation (within the meaning of s 109D(3)) to the trustee of a trust or which in substance effects a Div 7A loan. This type of loan is referred to as a "section 3 loan" in TR 2010/3.

A private company provides financial accommodation pursuant to s 109D(3) if it provides any pecuniary aid or favour to the trustee of a trust under a consensual agreement. TR 2010/3 sets out the Commissioner's opinion as to the circumstances in which this will arise. Paragraph 21 provides:

> *21. A consensual agreement for the provision of a pecuniary aid or favour to the trustee of a trust arises if a private company beneficiary authorises (including by acquiescing with knowledge of) the trustee's continued use for trust purposes of the funds representing the private company's [unpaid present entitlement] by not calling for:*
>
> - the payment of that [unpaid present entitlement]; or
> - the investment of the funds representing the [unpaid present entitlement] for the private company's sole benefit rather than their use for the benefit of the trust.

In effect, section 3 loans relate to the circumstances of an unpaid present entitlement becoming a loan as a result of the provision of financial accommodation at some time after the creation of the unpaid present entitlement. The rationale on which the unpaid present entitlement is converted to a loan is based on the fact that the beneficiary company has knowledge that the funds representing the unpaid present entitlement are being used for the purposes of the trust as opposed to being used or held for the sole purpose of the beneficiary company. TR 2010/3 para 26 provides in relation to the knowledge of the beneficiary company that:

> *26. Where the trust and beneficiary form part of the same family group, in absence of sufficient evidence to the contrary, the Commissioner takes the view that the private company has knowledge of the trustee's use of the funds representing the [unpaid present entitlement] for trust purposes.*

Appendix 1 considers the meaning of "financial accommodation" in detail including consideration of the decision of the Administrative Appeals Tribunal in *Eldersmede Pty Ltd & Ors and FCT* [2004] AATA 710 and the decision of the Full Federal Court in *Corporate Initiatives Pty Ltd & Ors v FCT* [2005] 142 FCR 279. Briefly, in both of these cases the beneficiary was found to have provided a benefit to the trustee of the trust as a result of its inaction. That is, the beneficiary provided a benefit to the trust by failing to either call for payment of its unpaid present entitlement or to call for the trustee to invest the amount of the unpaid present entitlement at a commercial return for its benefit.

The ruling sets out the Commissioner's opinion that funds representing an unpaid present entitlement will be seen as being used for trust purposes, and therefore the provision of financial accommodation, if they remain intermingled with the trust funds of the trust and are used other than for the sole benefit of the beneficiary (TR 2010/3 para 103). To avoid the provision of financial accommodation by a beneficiary company to the trustee of a trust, the use of sub-trusts is essential. However, even if a sub-trust is created, there may still be the provision of financial accommodation in certain circumstances.

It is made clear by the ruling that, if the funds held in the sub-trust continue to be used for the purposes of the main trust with the knowledge or acquiescence of the beneficiary company, there may still be provision of financial accommodation by the beneficiary company (TR 2010/3 paras 103 and 104).

Unpaid present entitlements arising on or after 16 December 2009 will be subject to the provisions of TR 2010/3 regarding section 3 loans.

Appendix 2 to TR 2010/3 includes a number of examples in relation to both section 2 loans and section 3 loans. These examples provide some guidance as to the circumstances which may give rise to a section 2 loan or section 3 loan.

PS LA 2010/4

PS LA 3362 was released on 2 June 2010 and subsequently finalised in the form of PS LA 2010/4, which was released by the ATO on 14 October 2010 with subsequent amended versions being released on 15 June 2011 and 1 July 2011 (being the final version). The practice statement provides practical guidance in relation to the application of the principles in TR 2010/3.

Loans within the ordinary meaning (section 2 loans)

Part B of the practice statement relates to section 2 loans and provides further guidance as to when the ATO is likely to consider that an unpaid present entitlement has been replaced by a loan by way of an express agreement, implied agreement, including by way of acquiescence, or alternatively pursuant to the trust deed.

In respect of the creation of a loan by way of *express agreement*, the practice statement sets out the view of the ATO that an express loan agreement will be evidenced by:

- a written agreement;
- a trust resolution; or
- another document.

In the circumstance of the creation of a loan by way of *implied agreement*, the practice statement outlines the view of the ATO that unless there is evidence to the contrary there will be an implied loan agreement where the amount is recorded in the financial accounts of the company as an asset in the form of a loan and in the financial accounts of the trust as a liability in the form of a loan (PS LA 2010/4 para 21). It should also be noted that a section 2 loan may arise where an amount recorded as an unpaid present entitlement in the accounts of the trust and the company is forgiven.

In relation to the circumstance of a loan being created *pursuant to a power in the trust deed*, the practice statement outlines the view of the ATO that the power in the trust deed will be taken as having been exercised where:

- the exercise of the power pursuant to the trust deed by the trustee is evidence by a trust resolution or other written document; and
- the financial accounts of the trust have recorded the amount as a loan.

It is clear that a section 2 loan will not be created where both the accounts of the trust and the company record the amount as an unpaid present entitlement as opposed to a loan.

Section 2 loans and self-correction until 31 December 2011

Subject to the conditions set out the practice statement being met, up until 31 December 2011 taxpayers have the following options available to them to deal with incorrect recording of unpaid present entitlements as loans in accounts:

- self-correct accounts where the unpaid present entitlement has been recorded as a loan; or
- operate on the basis that the Commissioner would exercise his discretion under s 109RB to disregard the deemed dividend.

The practice statement provides that a private company will be able to correct their accounts, such that the ATO will accept that the relevant amount is not a loan, if an unpaid present entitlement has been misclassified as a loan where:

> *(a) the financial accounts of the trust and/or the private company have incorrectly classified the amount, which is in fact a [unpaid present entitlement], as a loan from the private company to the trust*
>
> *(b) with the exception of the financial accounts and their underlying working papers, including the journal entries, accounting ledgers and/or trial balance, all available evidence supports the view that the amount is in fact a UPE*
>
> *(c) the private company has never included that amount in calculating the amount of loan reported at Label 8N of the private company's income tax return (label marked 'loans to shareholders and their associates')*
>
> *(d) the trust has not paid or credited any interest on or in respect of that amount*
>
> *(e) the loan account in which the amount is included is entirely comprised of amounts correlating to [unpaid present entitlements] and repayments of such [unpaid present entitlements] between the trust and the private company (that is, its balance is not affected by any unrelated transactions)*
>
> *(f) on or before **31 December 2011**, the financial accounts of all relevant entities are amended to properly classify the amount as a [unpaid present entitlement]*
>
> *(g) on or before **31 December 2011**, the trustee of or public officer of the trust, or public officer of the company, (as is relevant) signs and dates a declaration setting out all of the above conditions listed in this paragraph in the context of the amount and declaring them to be true and correct.*

In relation to the application of the Commissioner's discretion in s 109RB, the practice statement (at para 34) provides that the taxpayer will not be required to make a written request to the Commissioner to exercise his discretion to disregard the dividend arise as a result of the creation of a section 2 loan where the conditions set out in para 34 of the practice statement are satisfied. These conditions include the following:

- that the failure to comply with one or more provisions of Div 7A in respect of the section 2 loan was as a result of an honest mistake or inadvertent omissions by the trustee, the private company or other relevant party;
- that both the trust and the private companies are small business entities (as defined in s 328-110 ITAA97) in the year in which the section 2 loan is made;
- the loan funds were used by the trust only for the purpose of carrying on the business of the trust;
- "corrective action" as set out in para 35 of the practice statement has been taken on or before *31 December 2011*;
- both the private company and the trust have lodged all required income tax returns up to and including the 2009-10 income year (if necessary);
- notwithstanding the current non-compliance with Div 7A, the family group, including the private company, the trust and their controlling mind(s), have a good history of tax compliance over the last four years; and
- the trustee of the trust is not a shareholder of the private company.

If the self-corrective options set out above are not available, the private company will need to apply directly to the Commissioner, in writing, to ask him to exercise the discretion in s 109RB to disregard each deemed dividend that has occurred.

Loans within the extended meaning (section 3 loans)

Part C of the practice statement relates to section 3 loans and provides further guidance as to when the ATO is likely to consider that an unpaid present entitlement becomes a section 3 loan. The practice statement (at para 40) makes it clear that the provisions of TR 2010/3 and PS LA 2010/4 apply to unpaid present entitlements arising from 16 December 2009.

Paragraph 46 of the practice statement summarises the circumstances in which an unpaid present entitlement will become a section 3 loan such that Div 7A applies as follows:

> *46. A [unpaid present entitlement] owing from a trust to a private company in the same family group will become a loan to which Division 7A applies to the extent that:*
>
> *(a) it has not been paid out to the private company beneficiary, and*
>
> *(b) the trustee fails to hold the funds representing the [unpaid present entitlement] on sub-trust for the sole benefit of the private company beneficiary by the main trust's lodgement day for the year in which the present entitlement arises and all time thereafter.*

In respect of unpaid present entitlements arising between 16 December 2009 and 30 June 2010, the trustee of the trust had until 30 June 2011 to put the funds representing the unpaid present entitlement on sub-trust and for the sole benefit of the private company beneficiary (paras 47 and 96 of the practice statement).

The practice statement outlines in detail what is necessary in order for a sub-trust to be created, being one of the fundamental elements in ensuring that an unpaid present entitlement does not convert to a section 3 loan. The following are some of the factors that the ATO will take into consideration when determining whether a sub-trust has been created:

- a resolution of the trustee or alternatively if the trust deed of the relevant trust expressly provides that an unpaid present entitlement is to be held on sub-trust and that the trustee has wide powers to invest the amount held on sub-trust the establishment of the sub-trust may happen without the requirement for a trustee resolution (paras 50 and 51);
- where the amount representing the unpaid present entitlement is set aside separately in the accounts of the main trust as being held on trust for the beneficiary company (para 52);
- where separate accounts are prepared for the sub-trust (para 52), in relation to which it should be noted that where the funds of the sub-trust are invested in a specific income producing asset (which is outlined below) this will be required (para 53); and
- where a separate bank account is opened in the name of the trustee as trustee for the beneficiary company (para 52).

The second fundamental element that must be present in order for an unpaid present entitlement not to convert to a section 3 loan is that the funds of the sub-trust are held for the sole benefit of the company beneficiary.

In relation to this issue, the practice statement provides the following:

> 55. *The ATO will consider that the funds in the sub-trust are held for the sole benefit of the private beneficiary company where:*
>
> - *the trustee of the sub-trust invests the funds representing the [unpaid present entitlement] in the main trust on commercial terms pursuant to a power as trustee to do so, and*
> - *all the benefits from the investment flow back to the sub-trust and the private company beneficiary; and*
> - *all the benefits (eg annual return on investment) are actually paid to the private company beneficiary by the lodgement day of the tax return of the main-trust for the year in which the return arises.*

In addition, para 58 of the practice statement goes further to provide that the ATO will consider the funds in the sub-trust are held for the sole benefit of the beneficiary company if the funds are invested in the main trust using one of the following investment options:

- invest the funds representing the unpaid present entitlement on an interest only seven-year loan (option 1, which is detailed in paras 62 to 73 of the practice statement);
- invest the funds representing the unpaid present entitlement on an interest only 10-year loan (option 2, which is detailed in paras 74 to 85 of the practice statement); or
- invest funds representing the unpaid present entitlement in a specific income producing asset or investment (option 3, which is detailed in paras 86 to 94 of the practice statement).

The following table (included in para 61 of the practice statement) summarises each of the three investment options.

	Option 1 — interest only seven-year loan	Option 2 — interest only 10-year loan	Option 3 — invest in a specific income producing asset or investment
Amount of the annual return	Main trust to pay interest calculated at the Benchmark interest rate to the sub trust.	Main trust to pay interest calculated at the Prescribed interest rate to the sub trust.	Sub trust is entitled to receive the share of net return (e.g. interest income or rental income) derived as a result of the specific asset or investment to the sub-trust.
	Sub trust to pay annual return to the private company beneficiary by the lodgment day of the income tax return for the main trust except for the final payment of the annual return which must be paid to the private company when the investment or loan is due to be repaid.		
Nature of the annual return	Interest.	Interest.	Depends on the specific asset or investment.
Repayment of the funds representing the UPE (the principal)	The principal must be repaid at the end of the seven-year loan.	The principal must be repaid at the end of the 10-year loan.	The principal must be repaid by the lodgment day of the tax return of the private company beneficiary for the year in which the investment ends.
Deductibility of the annual return	Yes, the amount is deductible to the main trust provided that the trustee of the main trust satisfies s 8-1 ITAA97.	Yes, the amount is deductible to the main trust provided that the trustee of the main trust satisfies s 8-1 ITAA97.	No.
Assessability of the annual return	Yes, the amount is assessable to the private company beneficiary.	Yes, the amount is assessable to the private company beneficiary.	Depends on the specific asset or investment.
Sub-trust tax return	Not required.	Not required.	Required.

The practice statement, in the explanation section, also includes a number of examples addressing both section 2 loans and section 3 loans and the issues arising out of each which are of some assistance in applying the terms of TR 2010/3 to the day-to-day conduct of trusts making appointments of income to private beneficiary companies.

TD 2015/20

The ATO released TD 2015/20 on 20 November 2015 (previously released as TD 2015/D4 on 10 June 2015). The determination discusses the ATO's opinion that the release of a UPE by a corporate beneficiary would constitute a "payment" for Div 7A purposes. The ATO concluded that the word "credit" in s 109C(3)(b) ITAA36 takes a wide meaning and includes any action or dealing that would properly be reflected as a credit entry in a private company beneficiary's books of account. A release (by way of deed or agreement) constitutes a binding undertaking, leaving the entity to whom the interest is released with full legal ownership, free of any separately identifiable equitable interest of the releasing beneficiary in the underlying property. Therefore, a release of a UPE should be treated as a credit in the corporate beneficiary's accounting books, and is considered a payment within the meaning of s 109C(3)(b)(iii) to the extent that a financial benefit is conferred on the entity to which the UPE is released. However, this determination would not apply in respect of UPEs that have already been converted to Div 7A loans.[3]

The post-implementation review

On 18 May 2012, the then Assistant Treasurer announced that the Board of Taxation would undertake a post-implementation review of Div 7A focusing on whether its legislation is operating as intended. Following a discussion paper issued in December 2012, the Board issued a second discussion paper in March 2014 extending its reporting date to 31 October 2014.

The discussion paper sets out some of the Board's preliminary observations of the policy framework in which Div 7A operates, and proposes five reforms:

(1) a unified set of rules based on the principle of transfer of value (ie have a single set of common principles dealing with loans, payments, debt forgiveness and the use of company assets);

(2) a better targeted framework for calculating a company's profits where assets revaluations will not be required and unrealised profits will not be taken to be distributed because company assets have been used, and company profits will be tested each year to appropriately tax all transactions;

(3) a simpler and better targeted system of "complying loans" with a single 10-year loan period, with more flexible requirements for the repayment of principal;

(4) a greater flexibility for trusts that reinvest UPEs as working capital. The paper proposed having a regime to provide trading trusts with a simple option to retain funds that have been taxed at the corporate rate and deny them CGT discount (except in relation to goodwill). The paper also proposed a system to clarify that all UPEs are loans for Div 7A purposes; and

(5) a self-correcting mechanism to enable taxpayers to put in place complying loan agreements, reduce compliance and administrative costs, and substantially reduce the number of cases that would require a decision by the Commissioner.

In June 2015, the government released the Board of Taxation's report on its post-implementation review of Div. 7A.[4] The report included recommendations to ease the compliance burden and lower the cost of working capital for private companies.

The Board of Taxation noted that some tax system features influence the way that businesses are structured. The Board suggests that, in the long-term, structural reform could be achieved by changing the way that trusts are taxed on business income, or by aligning the treatment of entities so that income is taxed at an appropriate "business tax" rate independent of the structure used.

3 See the discussion in R Somers and A Eynaud, "The ATO's proposed treatment of unpaid present entitlements: part 1", (2015) 50(2) *Taxation in Australia* 90, as to the ATO's proposed treatment of UPEs in TD 2015/D5 and TD 2015/D4.

4 Website at www.taxboard.gov.au/content/reviews_and_consultations/division_7A/report/downloads/Division7a_Report.pdf.

The Board of Taxation's report suggests that the first step in the process of improving Div 7A is to develop a coherent set of policy principles. Therefore, the Board proposes four guiding principles:

(1) it should ensure that the private use of company profits attracts tax at the user's progressive personal income tax rate;

(2) it should remove impediments to the reinvestment of business income as working capital;

(3) it should maximise simplicity by reducing the compliance burden on business and the administrative burden on the Commissioner and other stakeholders; and

(4) it should not advantage the accumulation of passive investments funded by profits taxed at the company tax rate over the reinvestment of business profits in active business activities.

An amortisation model under which loans would be repayable over a 10-year period with more flexible requirements for the payment of the principal was developed by the Board to give effect to these principles.

The amortisation model intends to assist trusts wishing to reinvest profits as working capital by offering a "business income election" exemption. Under the exemption, UPEs owed to corporate beneficiaries will not be subject to Div 7A if the trustee agrees to forgo the CGT discount concession on assets other than goodwill.

The Board has also proposed an interest-only model in case the government adopts a policy framework that omits the fourth principle. Under the interest-only model, Div 7A loan agreements would bear interest at a specified rate but principal payments would not be required.

Interim reforms have been also proposed by the Board in its report. Accordingly, they can be adopted in conjunction with either the amortisation model or the interest only model. They are:

(1) simpler rules for regulating the use of company assets by shareholders and associates;

(2) a self-correction mechanism that would help ensure compliance by taxpayers who inadvertently breach the provisions, coupled with proportionate penalties to promote voluntary compliance; and

(3) a new approach to imposing and remitting administrative penalties on deemed dividends, to reduce the implicit additional penalty that can arise as a result of deemed dividends being unfranked.

¶7-120 In specie distributions and GST

One of the advantages of holding assets through a discretionary trust (provided the power is in the trust deed) is the ability to distribute assets to one or more beneficiaries of the discretionary trust in the form in which those assets are held by the trustee (an in specie distribution), rather than conversion of the assets to cash prior to distribution. The flexibility of the method by which these distributions are made is generally not available through corporate structures where rights held by shareholders must be considered and the procedure for capital reductions in the *Corporations Act 2001* must be followed.

Careful consideration is often given to the income or capital gains tax consequences of an in specie distribution and, in some jurisdictions, the availability of exemptions from stamp duty. However, the GST implications are often overlooked. It is important that the GST implications are addressed.

No consideration

By the nature of the distribution and the recipient beneficiary's rights in respect of the trust capital, consideration is usually not provided by the recipient beneficiary of an in specie distribution. In nearly all discretionary trust deeds (again depending on the terms of the deed) the beneficiary in receipt of an in specie distribution does not forgo any rights in exchange for the distribution. A fundamental feature of a discretionary trust is that usually, the beneficiary does not have any fixed right in respect of the income and capital of the trust. The beneficiary is a mere object of the trust, and accordingly only has the right to the due administration of the trust.

Aside from the circumstances where liabilities have been assumed by the beneficiary, in receipt of an in specie distribution, beneficiaries of discretionary trusts often provide no consideration in respect of that distribution. In fact, if consideration is provided it is arguable that the transfer is really a sale of the asset rather than an in-specie distribution.

Taxable supply

In general terms, in order for there to be a GST liability in respect of a supply, the supply must be a "taxable supply" in accordance with the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act). Section 9-5 GST Act provides that four elements must be present for there to be a taxable supply:

- a supply is made for consideration;
- the supply is made in the course or furtherance of an enterprise you carry on;
- the supply is connected with Australia; and
- you are registered or required to be registered.

In considering whether an in specie distribution is a taxable supply, it is tempting to simply note that there is no consideration and conclude that the supply is not a "taxable supply". Even when turning to the definition of "consideration" in s 9-15 GST Act, the same conclusion can be reached. However, even if there is no consideration in terms of the GST Act, which is an important point in respect of the margin scheme discussed below, the GST Act may still treat the supply as a taxable supply.

Associates

Division 72 GST Act contains a series of special rules designed to treat supplies between associates as taxable supplies. "Associate" is defined in s 195-1 GST Act as having the same meaning as given by s 318 ITAA36. Section 318(3)(a) provides that any entity that benefits under a trust is an associate of the trustee of the trust. Further, s 318(6)(a) provides that a reference to an entity benefiting under the trust includes a reference to an entity being capable of benefiting under the trust. Interestingly, for the purposes of s 318 a beneficiary is an associate of the trustee of the trust, not the trust itself, ITAA36 reflecting the position at law that the trust is not a separate legal entity. However, for the purposes of the GST Act, a trust is an entity (s 184-1) and as such would be the supplier for GST purposes in respect of the in specie distribution.

The position adopted by the ATO in a series of interpretative decisions (ID 2001/503, ID 2001/504, and ID 2001/505) is that the associate rules in Div 72 would apply to an in specie distribution by the trustee of a discretionary trust to a beneficiary.

Status of beneficiary

Assuming that the discretionary trust and the beneficiary are associates for the purposes of the GST Act, s 72-5 provides that in certain circumstances a supply without consideration will be a taxable supply despite s 9-5.

The section provides that, where:

- the beneficiary is not registered or required to be registered, or
- the beneficiary acquired the thing otherwise than solely for a creditable purpose,

the supply by way of the in specie distribution to the beneficiary will be a taxable supply. The logic of the provision is that if the beneficiary is registered or required to be registered and could claim input tax credits for the whole of any GST payable on the supply, the supply would be tax neutral and there is no reason to impose GST in those circumstances. Alternatively, where those conditions are not satisfied there is an amount of GST that would not be recovered by the beneficiary by way of input tax credits and failure to treat that supply as a taxable supply may result in lost GST revenue.

To clarify, the only effect of Subdiv 72-A is that the requirement in s 9-5(a) is waived; that is, the supply may still be a taxable supply even where no consideration is provided. The remaining components of a taxable supply:

- that the supply is made in the course or furtherance of an enterprise you carry on;
- that the supply is connected with Australia; and
- that you are registered or required to be registered,

must still be satisfied.

In relation to the requirement that the supply is made "in the course or furtherance of" the enterprise carried on, the ATO in GSTD 2009/1 sets out the view that a supply by way of in specie distribution of an asset that is applied in an enterprise carried on by a discretionary trust to a beneficiary of the trust is likely to be made "in the course or furtherance of" the trust's enterprise.

In coming to this conclusion, the ATO refers to the explanatory memorandum to the A New Tax System (Goods and Services Tax) Bill 1998 which supports a broad meaning of the phrase "in the course or furtherance of". It is noted in GSTD 2009/1:

> *[7] Having regard to the context in which the phrase "in the course or furtherance of" appears and the above statement from the Explanatory Memorandum, the phrase should be given a broad meaning so as to encompass supplies made in connection with the relevant enterprise. By distinguishing an act done for the purpose or object of furthering an enterprise from an act done in the course of an enterprise, the Explanatory Memorandum illustrates that a supply may be made in connection with the relevant enterprise without the supply furthering or achieving the goals of the enterprise.*
>
> *[8] …*

> [9] *The application of an asset in an enterprise establishes the necessary connection between the supply of the asset and the relevant enterprise. The fact that the supply in question was made by way of an in specie distribution rather than by sale does not alter the analysis. Entities can dispose of assets in a number of ways. The method of itself is not relevant to whether the supply is in the course or furtherance of the enterprise.*

GSTD 2009/1 makes it clear that it is the view of the ATO that it will be "an exceptional circumstance" for the supply of an asset that is applied in the supplier's enterprise to not have a connection with the enterprise. An example of such an exception is provided, being the transfer of enterprise assets as a result of property distributions under the *Family Law Act 1975* (refer to GSTR 2003/6).

The AAT has recently held in *Anderson and FCT* [2015] AATA 167 that a trustee of a family trust involved in a property development project was liable for the GST payable in respect of the sale of two individual lots that were part of the project. The sales of these two lots were settled on 13 October 2009 and 19 November 2009.

The trustee claimed that he was not liable for the GST in respect of the sales because, first, the trustee was an "incapacitated entity" for the purposes of the *A New Tax System (Goods and Services Tax) Act 1999*, and second, he had retired as a trustee on 9 December 2009.

The AAT found that the taxpayer was the trustee when the two lots were settled as he did not retire until 9 December 2009.

The AAT also rejected the argument that the trustee was an "incapacitated entity". There was no evidence that the mortgagee made any sales in the relevant period as mortgagee in possession. Further, the power of sale in the case was not exercised by the mortgagee, even though the mortgagee was in a position to exert pressure on the trustee.

No deeming of consideration

Where no consideration is provided for the supply, Subdiv 72-A does not deem consideration for the purposes of the GST Act. Instead, to calculate the GST liability, the provisions deem a "value" for the supply. The amount of any GST on a taxable supply is calculated pursuant to Subdiv 9-C on the basis of "value" of the taxable supply. Subdivision 72-A deems that the "value" of a taxable supply without consideration between associates is the "GST exclusive market value" of the supply.

> For example, if a trustee of a discretionary trust makes an in specie distribution of a block of land to a beneficiary of that trust for nil consideration and all the pre-conditions for a taxable supply (save for consideration) are satisfied, the in specie distribution of the block of land may be a taxable supply. To determine the status of the supply, the position of the beneficiary needs to be analysed. If the beneficiary is not registered or required to be registered, or does not acquire the block of land solely for a creditable purpose, the in-specie distribution will be treated as a taxable supply to the beneficiary. The GST is then calculated on a deemed value for the supply equivalent to the GST exclusive market value of the block of land.

Although the process of deeming a "value" for the supply is effective for determination of the GST liability on the supply between associates, the failure to deem consideration as having passed in the transaction (rather than simply ignoring that requirement) creates difficulties in respect of the margin scheme.

Margin scheme

If a supplier makes a taxable supply of real property, provided that certain conditions are satisfied, the margin scheme allows the supplier to elect to impose GST only on the "margin" for the supply. The method of calculation of the "margin" for the supply will depend on the date of acquisition of the real property subject to the supply and whether the supplier was registered or required to be registered at the time of acquisition. Normally, where the supplier acquired the property after 1 July 2000, the margin for the supply is the amount by which the consideration for the supply exceeds the consideration for the original acquisition.

Recent amendments to Div 75 GST Act outline additional circumstances where supplies are ineligible for the margin scheme. One of the amendments, effective as from 9 December 2008 addresses supplies between associates. The relevant circumstances by which such a supply will be ineligible for the margin scheme (in addition to other circumstances where the supply might otherwise already be ineligible for the margin scheme) are outlined in s 75-5(3)(g). That section provides as follows.

75-5(3) A supply is ineligible for the margin scheme if:

…

(g) it is a supply in relation to which all of the following apply:

(i) you acquired the interest, unit or lease from an entity who was your associate, and who was registered or required to be registered, at the time of the acquisition;

(ii) the acquisition from your associate was without consideration;

(iii) the supply by your associate was not a taxable supply;

(iv) your associate made the supply in the course or furtherance of an enterprise that your associate carried on;

(v) your associate had acquired the entire interest, unit or lease through a taxable supply on which the GST was worked out without applying the margin scheme.

In addition to the amendments concerning eligibility, amendments have been made to the manner in which the margin itself is calculated. It is beyond the scope of this guide to consider each of those various circumstances but it is important to consider the requirements in Div 75 and in particular ss 75-11 and 75-13 carefully whenever attempting to apply the margin scheme to a supply between associates.

Board of Taxation review

Following the Board of Taxation review, the government has undertaken to reform the margin scheme provisions to clarify their operation and simplify compliance with effect from 1 July 2012. As a starting point, it is proposed that an approved valuation of the GST-inclusive market value be used for the purposes of calculating the margin on subdivided land.

¶7-125 Resettlements

One of the many dangers encountered when dealing with trust estates is the potential to inadvertently create a new trust by undertaking a variation or amendment to the trust deed or by entering into an arrangement concerning the trusts, beneficiaries or control over the trust estate. More recently, many practitioners have been concerned about the potential to "resettle" a trust estate when varying the trust deed to modernise its provisions concerning income, capital and the manner in which amounts comprising either are distributed.

While this paragraph is focused on the income tax consequences relating to the creation of a new trust estate rather than the state duty implications concerning settlements of trusts, the common term "resettlement" will be used interchangeably throughout this paragraph to describe the process of the creation of a new trust estate.

Consequences of the creation of a new trust

There is reason to be concerned. The consequences of inadvertently creating a new trust are great. A number of tax consequences may arise if the original trust is terminated and a new trust is created including triggering liabilities to stamp duty, the imposition of capital gains tax, income tax, or the loss of beneficial tax characteristics such as carried forward tax losses. Further, the taxation liabilities may be incurred at a time when the gain is only realised for tax purposes. As far as the parties are concerned, the underlying assets and any inherent gain remains unrealised such that there are either insufficient funds available to meet the tax liability or the gain that is triggered for tax purposes is illusory and ultimately never truly realised.

Capital gains tax

If a resettlement occurs, for the purposes of the CGT provisions the property of the original trust is treated as being disposed of and acquired at deemed market value. That is, the original trust is deemed to have disposed of trust property to the new trust. The property previously held in the original trust will be realised at the trustee level. Further, the beneficiaries/unitholders in the original trust are deemed to have disposed of their interests in the original trust and acquired interests in the new trust at deemed market value. Depending on the cost base of the assets disposed of, there is the possibility of significant liabilities to CGT being incurred as a result of a resettlement.

Income tax

For income tax purposes, if a resettlement occurs there is a disposal and acquisition at deemed market value for both depreciation and trading stock purposes. This can lead to significant taxation liabilities. Some of those taxation liabilities relate to potential future liabilities being brought forward (eg trading stock that would have ultimately been sold at market value). Some are liabilities that would not have otherwise been incurred.

Tax liabilities that would not have occurred without the resettlement include the tax payable on the deemed disposal of trading stock at market value (where that trading stock may not ultimately be able to be sold for its current purported market price) and balancing adjustments to depreciable items such as plant and equipment which may have otherwise been written off.

Tax benefits

Any carry-forward tax benefits available to the original trust entity (including tax losses) will be trapped in the original trust. Ultimately those tax benefits will be lost as the result of the resettlement in that all of the assets of the original trust are transferred to the new trust and the original trust ceases to exist.

Stamp duty

Where a variation to a trust gives rise to a resettlement, stamp duty may be payable where the variation of trust constitutes either a declaration of trust over "dutiable property" or a transfer of "dutiable property". Whether the assets of the trust constitute dutiable property will depend on the relevant revenue law in the state where the assets are located. For example, in Victoria, only trusts holding land would be affected. However, in most other states trusts with any kind of business or investment assets would likely be affected.

Current state of the law

The state of the law is a principal difficulty for tax practitioners in advising clients as to whether certain activity is likely to trigger a resettlement of a trust.

As noted at [88] of the judgment of Edmonds and Gordon JJ in *FCT v Clark* [2011] FCAFC 5 (*Clark's* case):

> *… In Commercial Nominees both the Full Court, at [49] of its reasons, and the High Court, at [35] of its reasons, pointed out that there was nothing in Pt IX, nor in the 1936 Act generally, which imposed some statutory requirement of continuity for determining when there is a sufficient identity of the trusts involved. With respect, the same applies in the case of Div 6 of Pt III of the 1936 Act.*

As such, practitioners have been faced with either considering older stamp duty case law, considering concepts such as the substratum of a trust (see *Kearns v Hill* (1990) 21 NSWLR 107), following the approach adopted by the High Court in *FCT v Commercial Nominees* [2001] HCA 33 (*Commercial Nominees*) or adopting the approach outlined by the Commissioner in his Statement of Principles.

In the case of *Commercial Nominees*, the High Court concluded that significant changes made to the trust deed of a superannuation fund did not create a new trust primarily because there was a continuing trust estate comprised by the property of the fund. Due to this continuity, the superannuation fund was entitled to deduct losses incurred in prior years. The Full Federal Court in that case[5] had concluded that, provided that any amendment of the trust obligations relating to trust property are made in accordance with the powers under the trust deed and the continuity of the trust property is established, there will be identity of the "taxpayer" for the purposes of the loss provisions applicable in that case. The court held that this "identity" is maintained notwithstanding any amendment of the trust obligation and any change in the property itself:

> *55. Thus, in order to determine whether losses of particular trust property are allowable as a deduction from income accruing to that trust property in a subsequent income year, **it will be necessary to establish some degree of continuity of the trust property** or corpus that earns the income from the income year of loss to the year of income. **It will also be necessary to establish continuity of the regime of trust obligations** affecting the property in the sense that, while amendment of those obligations might occur, any amendment must be in accordance with the terms of the original trust.*

5 *FCT v Commercial Nominees of Australia* [1999] FCA 1455

> *56.* ***So long as any amendment of the trust obligations relating to such trust property is made in accordance with any power conferred by the instrument creating the obligations, and continuity of the property that is the subject of trust obligation is established, there will be identity of the "taxpayer" for the purposes of section 278 and sections 79E(3) and 80(2), notwithstanding any amendment of the trust obligation and any change in the property itself.*** (emphasis added)

The Commissioner sought special leave to appeal the decision of the Full Federal Court in *Clark's* case to the High Court. On 2 September 2011, the High Court denied the Commissioner's request for special leave ([2011] HCATrans 236).

The Commissioner released a decision impact statement on 2 December 2011.

In the Draft Consultation Sub-group meeting in October 2011, the ATO sought members' views on the draft DIS for *Clark* that had been circulated to them. During the meeting, one of the main issues that the members sought from the ATO was an acknowledgment in the DIS that the decision in *Commercial Nominees* should not be limited to superannuation entities. The "Decision Impact Statement on *FCT v David Clark*; *FCT v Helen Clark* [2011] FCAFC 5" outlined the ATO view of the Full Federal Court case. Although the DIS does not specifically state that *Commercial Nominees* is not limited to superannuation entities, the DIS did not appear to restrict the decision to superannuation entities.

In terms of administrative treatment, the DIS stated the following:

> *Even though this case considered whether changes in a continuing trust were sufficient to treat that trust as a different taxpayer for the purpose of applying a net capital loss, the ATO accepts the principles set out in this case may have broader application. In particular, the case is relevant to the question of the circumstances in which CGT Event E1 may happen by reason of a new trust coming into existence consequent on changes being made to an existing trust. Therefore, the ATO will review the "Creation of a new trust – Statement of Principles August 2001". The ATO is liaising with the NTLG Trust Subgroup in this regard.*

ATO statement of principles

The ATO withdrew its "Creation of a new trust – statement of principles August 2001"[6] (statement of principles) on 20 March 2012, following the Full Court's decision in the *FCT v Clark*[7] (*Clark*) and the High Court's refusal to grant the Commissioner leave to appeal.

The Commissioner's view, prior to the statement of principles being withdrawn, was that there was no resettlement of a trust if the amendment was a mere variation of a continuing trust. Therefore, a new trust would only be created if there was a "fundamental change" to the "essential nature and character of the original trust relationship". However, the test was difficult for taxpayers to apply and the Commissioner interpreted it quite broadly in the statement of principles.

6 "Creation of a new trust – statement of principles" was originally released on 9 June 1999.

7 [2011] FCAFC 5.

The statement of principles provided a list of possible changes to a trust which may result in a new trust being created:

- any change in beneficial interest in trust property;
- a new class of beneficial interest (whether introduced or altered);
- a possible redefinition of the beneficiary class;
- changes in the terms of the trust or the rights or obligations of the trustee;
- changes in the nature or features of trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of the trust property;
- a change in the termination date of the trust;
- a change to the trust that is not contemplated by the terms of the original trust;
- a change in the essential nature and purpose of the trust; or
- a merger of two or more trusts or a splitting of a trust into two or more trusts.

A resettlement of a trust, compared with a mere variation to a continuing trust, therefore depended on the nature and extent of the changes made to the trust.

The position adopted by the Commissioner in the statement of principles was subject to a significant level of criticism by commentators and practitioners.

The significance of Clark

In *Clark*, the taxpayers had executed a series of documents that were ancillary to the trust deed and the effect of which included:

- changing the trustee;
- altering the ownership of the units of the trust;
- extinguishing liabilities of the trust;
- extinguishing the former trustee's right of indemnity out of trust assets;
- altering the corpus of the trust; and
- changing the activity of the trust.

In 2001, the trust sought to apply the carry-forward tax losses against an assessable capital gain. The Commissioner then contended that there was a lack of continuity between the trust that incurred the losses in the early 1990s and the trust that derived the capital gain in 2001, such that the capital losses could not be applied against the capital gain.

The Federal Court at first instance held that the elements providing evidence of continuity identified in *Commercial Nominees* also applied to trusts for the purposes of the ITAAs and found that there had been continuity of the trust estate such that the losses could be carried forward and applied against the 2001 financial year capital gain. The decision of the Federal Court was upheld on appeal at the Full Federal Court. The High Court rejected the Commissioner's application for special leave to appeal the decision of the Full Federal Court.

As compared to the confusing selection of trust law concepts previously adopted by the Commissioner in the now withdrawn statement of principles, the decision of the Full Court in *Clark* provides significant assistance to tax practitioners in the following respects:

The Full Court applied the principles in *Commercial Nominees* to trust estates other than superannuation funds.

The majority decision of Edmonds and Gordon JJ stated that the High Court in *Commercial* Nominees clearly endorsed the Full Court's framing of the criteria to be used when determining continuity of a trust estate, being:

(1) continuity in trust property;

(2) continuity in membership; and

(3) continuity in trust obligations.

Although the judges disagreed on the application of the indicia of continuity of trust property,[8] both the majority and dissenting judgments considered and analysed how the general principles from *Commercial Nominees* could be applied to the facts in *Clark*.

In relation to the continuity in trust property, the majority found:

> *… When the High Court in Commercial Nominees spoke of trust property and membership as providing two of the indicia for the continued existence of the eligible entity or trust estate, the Court was not suggesting that there had to be a strict or even partial identity of property … and objects…... It was speaking more generally: that* ***there had to be a continuum of property and membership, which could be identified at any time, even if different from time to time; and without severance of one or both leading to the termination of the trust in question*** *…* (emphasis added)

All of the judges concluded that there had been continuity in membership, an acknowledgment that the trust deed contemplated changes in the beneficial ownership of the trust estate.

In relation to the continuity in trust obligations, the majority approved the Full Court's comments as to variations to trust obligations not impacting on the continuity of the trust estate where those variations are "made in accordance with any power conferred by the instrument creating the obligations".[9]

The ATO's DIS in response to Clark

The ATO has revised its DIS on *Clark*, by amending the section titled "Administrative Treatment" of the case. That section now reads as follows with the recent amendment marked in bold text.

> *Even though this case considered whether changes in a continuing trust were sufficient to treat that trust as a different taxpayer for the purpose of applying a net capital loss, the ATO accepts the principles set out in*

8 Dowsett J finding that there was no continuity of the property of the trust estate (at [45]) and Edmonds and Gordon JJ finding that there was such continuity (at [87]).

9 At pp 78 and 79.

> *this case have broader application. In particular, the case is relevant to the question of the circumstances in which CGT Event E1 may happen by reason of a new trust coming into existence consequent on changes being made to an existing trust.* ***In that context the ATO accepts that the reasoning of the court has the effect that a valid amendment to a trust, not resulting in a termination of the trust will not of itself result in the happening of CGT event E1. On this basis the "Creation of a new trust – Statement of Principles August 2001" was withdrawn on 20 April 2012.*** (emphasis added)

This revised statement reflects the principles established in the case law that a mere variation or change to a trust will not constitute a resettlement of a trust, and therefore will not have capital gains tax consequences, unless there is a lack of continuity in the:

(1) constitution of the trust;

(2) trust property;

(3) trust beneficiaries.

As explained in *Clark*, there does not need to be strict compliance with these indicia of continuity. However, there must be a continuum, such that the original trust has not been terminated.

TD 2012/21

TD 2012/21 was originally issued on 13 June 2012 (as TD 2012/D4) and provides that CGT event E1 (which occurs when a new trust is created over a CGT asset) or event E2 (which occurs when a CGT asset is transferred to a trust) do not happen if, pursuant to a valid exercise of a power contained within the trust's constituent document, the terms of the trust are changed.

According to the determination, CGT events E1 or E2 only occur in relation to an amendment where that amendment results in the trust being terminated for trust law purposes, or where the effect of the amendment or court-approved variation is to lead to a particular asset being subject to a separate charter of rights and obligations such as to give rise to the conclusion that that asset has been settled on terms of a different trust.

In the determination, the Commissioner states the following, accepting that the Full Federal Court decision in *Clark* means that the approach formerly set out in the statement of principles (now withdrawn) is unsustainable:

> *20. It is clear following Clark that, at least in the context of recoupment of losses, continuity of a trust estate will be maintained so long as the trust is not terminated for trust law purposes. As such, in the absence of termination, tax losses being carried forward by a trustee will as a general rule remain available to be recouped against relevant trust income derived in future years of income.*
>
> *21. Furthermore, as a general proposition, it would seem that the approach adopted by the Full Federal Court in Commercial Nominees, as explained by Edmonds and Gordon JJ in Clark,[3] is authority for the proposition that assuming there is some continuity of property and membership of the trust, an amendment to the trust that is made in proper exercise of a power of amendment contained under the deed will not have the result of terminating the trust, irrespective of the extent of the amendments so made so long as the amendments are properly supported by the power. Relevantly, in Commercial Nominees the Full Federal Court had stated that:*

> 55. *… in order to determine whether losses of particular trust property are allowable as a deduction from income accruing to that trust property in a subsequent income year,* ***it will be necessary to establish some degree of continuity of the trust property or corpus*** *that earns the income from the income year of loss to the year of income.* ***It will also be necessary to establish continuity of the regime of trust obligations affecting the property in the sense that, while amendment of those obligations might occur, any amendment must be in accordance with the terms of the original trust****.*
>
> 56. ***So long as any amendment of the trust obligations relating to such trust property is made in accordance with any power conferred by the instrument creating the obligations, and continuity of the property that is the subject of trust obligation is established****, there will be identity of the 'taxpayer' for the purposes of section 278 and sections 79E(3) and 80(2), notwithstanding any amendment of the trust obligation and any change in the property itself.*

22. *The Commissioner formerly had been of the view that the High Court in Federal Commissioner of Taxation v. Commercial Nominees of Australia Ltd [2001] HCA 33; 2001 ATC 4336; (2001) 47 ATR 220 had advanced what on its face appeared to be a different test. That is, in the Commissioner's view at the time, the High Court had seemed not only to focus on whether the trust had come to an end, but had also envisaged that changes to one or more of the property, membership and operation of a trust might be sufficient to result in a loss of continuity even if the trust had not terminated.*

23. *However in light of the Federal Court's decision in Clark, and the High Court's disposal of the Commissioner's special leave application, it is apparent that continuity of trust is a function of whether the trust continues in existence under trust law in contradistinction to having terminated. As so understood, the comments made by the Federal Court in Commercial Nominees relating to amendments to trust obligations represent good law.*

The Commissioner considers that the test to be applied looks to whether changes to one or more of the trust's constituent documents, the trust property, and the identity of those with a beneficial interest in the trust property are such as to terminate the existence of the trust. The Commissioner has provided examples of valid variations of trust deeds in the determination, which were accepted as not having a resettlement capital gain tax consequence:

Example 1: addition of new entities to class of objects

2. *The Acorn Trust is a family discretionary trust that was settled to benefit the members of the Squirrel Family. Under the terms of the trust deed the trustee, a private company of which Mr and Mrs Squirrel are directors, has the power at its absolute discretion to appoint income to any one or more of the General Beneficiaries defined to include Mr Squirrel, his wife, their children, their grandchildren, and entities associated with the family. The trust deed for the Acorn Trust provides for a procedure for the trust to be amended, namely by trustee resolution recorded in writing. Pursuant to this procedure the trustee resolves in writing to amend the deed to add to the class of General Beneficiaries the respective spouses of the children. The making of the resolution, being a valid exercise of a power of amendment contained within the deed, does not give rise to the happening of a CGT event …*

Example 3: addition of definition of income and power to stream

4. The Lime Trust is a discretionary trust settled to benefit the members of the Linden family. The deed contains no definition of income nor does the deed contain a provision permitting the trustee of the trust to stream income.

5. Pursuant to an unfettered power of amendment in the deed the trustee resolves in writing to amend the deed to insert two clauses:

- *the first defining the income of the trust to equal the net income of the trust as calculated under section 95 of the Income Tax Assessment Act 1936 (ITAA36), excluding franking credits, unless the trustee otherwise determines; and*
- *the second authorising the trustee to separately identify and label various sources of income or receipts that form part of the income of the trust estate and to deal with those amounts by reference to their labelling (that is, to 'stream' particular sources of income to particular beneficiaries).*

6. The making of the resolution, being a valid exercise of a power of amendment contained within the deed, does not give rise to the happening of a CGT event.

There are also examples in relation to the expansion of the power to invest (described as not giving rise to the happening of a CGT event), the addition of a definition of income, power to stream, and extension of the vesting date (described as not giving rise to the happening of a CGT event) and the settling of a trust asset on a new trust (described as giving rise to the happening of CGT event E1).

In *Oswal v FCT* [2013] FCA 745, the Federal Court held that a trustee's resolution appointing company shares "for the absolute benefit of named beneficiaries" was not merely a creation of a separate fund, but also a declaration of trust and a settlement. As a result, the court found that CGT event E1 had occurred, generating a capital gain for the trust in accordance with s 104-55 ITAA97. Edmonds J observed:

> *[45] According to the ordinary meaning of the English language, if in exercise of a power of appointment the donee of the power constitutes a trust by transfer of property to a trustee for the benefit of the object of the power, the trust thereby constituted is aptly described as a trust created by the transfer of property to a trustee. Equally, if in exercise of a power of appointment the donee of the power declares that he or she will henceforth stand possessed of the subject matter of the power on trust for the object of power, the trust thus constituted is aptly described as a trust constituted by declaration of trust. Contrary to the argument which was advanced on behalf of the respondent, there is in my opinion nothing in legal principle or in the texts to which we were referred or in common sense to suggest that any other view of the matter should be taken.*
>
> *[46] I consider that the Declaration was a declaration of trust according to the conventional meaning of that conception and that it was a declaration of trust within the meaning of [the statute].*

The Federal Court found that Mr Oswal was not only making an appointment, but also declaring that he would hold part of the company's shares on a separate trust for the absolute benefit of himself and of his wife, giving rise to the happening of CGT event E1.

While the court noted that the declaration did constitute a resettlement, it found it unnecessary to deal with the Commissioner's alternative claims that the effect of the declaration resulted in a resettlement.

On 8 August 2014, the Federal Court refused the taxpayer's leave to appeal to the Full Federal Court against the decision of Edmonds J.

It would seem that, following *Clark* and TD 2012/21, amendments to trust deeds if carefully made, and pursuant to a valid power of amendment which is validly exercised, should not affect the continuity of the trust estate.

¶7-130 Family trust elections

The family trust regime is contained in Sch 2F ITAA36. The measures were initially intended as a mechanism to ensure that only those persons who bore the economic loss relating to a revenue loss for tax purposes or in relation to bad debts obtained any tax benefit associated with that loss or bad debt. The regime has subsequently been extended such that it is also used in relation to the franking credit trading rules and the company loss recoupment rules.

The provisions operate by defining a family group based on an identified individual (the test individual) who alone or with others has some control in relation to operation of the trust. Entities can elect to be included within the family group of the test individual. The election in relation to the primary trust is called the "family trust election" (FTE) and the election made by a second entity to be included within the family group of the test individual is called an "interposed entity election" (IEE).

One of the consequences of making the elections is that effectively the provision of any type of benefit to someone outside of the family group of the test individual triggers a liability to family trust distribution tax. Family trust distribution tax is calculated at the top marginal rate plus the Medicare levy.

Revocation

Prior to amendments to Sch 2F ITAA36 by the *Tax Laws Amendment (2007 Measures No. 4) Act 2007*, one of the issues with the family trust regime was that once an election was made, it was generally irrevocable save for specific limited circumstances relating to fixed trusts. Schedule 8 of the *Tax Laws Amendment (2007 Measures No. 4) Act 2007* introduced additional circumstances in which an election may be revoked. The circumstances are limited to those when the FTE has not been relied on in accessing tax benefits (s 272-80(6A) ITAA36) and where the revocation happens within a limited period of time (s 272-80(6B) ITAA36).

Reliance

If the taxpayer could still have accessed the relevant tax benefit without making the FTE, then the FTE is treated as not having been relied on and therefore may be revoked.

Timing restrictions

The time period in which the FTE may be revoked is limited. Generally the period expires at the end of the fourth income year after the income year specified in the relevant FTE. Therefore, if an FTE was made specifying the 2006-07 income year, that FTE may be revoked for any income year up to the 2010-11 income year. The FTE is then only in force for the purpose of the tax legislation from the commencement period up to the end of the income year before the year in which the FTE was revoked. For example, if the FTE commenced in the 2006-07 income year and was revoked with effect from the 2009-10 income year, then that FTE will only be in force from 1 July 2006 through to 30 June 2009.

There is also a transitional rule that allows the FTE to be revoked in the period beginning at the start of the income year in which the provisions commence and at the end of the subsequent income year (s 272-80(6B) ITAA36); accordingly, the transitional period commenced 1 July 2007 and will end 30 June 2009.

FTE must be made in error

In addition to there being no reliance on the FTE, the restrictions as to when the FTE may be revoked appear to be limited to circumstances when the election was made in error and that error has been identified within the time periods allowed above.

Further compliance matters in requesting a revocation

The revocation of the FTE must also be made in the tax return of the trust for the income year in which the revocation is sought (s 272-80(8) ITAA36). If the trust does not need to lodge a tax return for the relevant year then the revocation must be in writing in an approved form specifying the income year from which the revocation is to be effective and must be given to the Commissioner on or before two months after the end of the relevant income year. There is a discretion for the Commissioner to accept revocations at a later point in time in (s 272-80(7)(c)(ii) ITAA36).

Similar rules apply in relation to the revocation of an IEE. Those provisions provide that an IEE is taken to be revoked if the FTE to which the IEE relates is revoked (s 272-85(5B) ITAA36). Further, an IEE may be revoked by an entity if that entity is or becomes a member of the family group, to which the IEE relates, by the operation of the new provisions referred to below (s 272-85(5A) ITAA36). Similar time period limitations and notification requirements apply to the revocation of an IEE as they do for the revocation of an FTE (s 272-85(5C) and (6) ITAA36).

Test individual

The amendments to the choice of the test individual allow rectification of errors in relation to an FTE.

Section 272-80(5B) ITAA36 provide for a once-only opportunity to vary an FTE by choosing a new test individual. To do so, s 272-80(5A)(a) ITAA36 requires that the new test individual must have been a member of the family of the original test individual as at the commencement time of the FTE. Further, in general terms there cannot have been an event that would have triggered a liability to family trust distributions tax by either the trust, or an entity that had made an IEE in relation to the trust. That liability is determined as if the new test individual had been the test individual throughout the time that the FTE had been in force. The actual provisions of the legislation refer to conferrals of a present entitlement to income and capital or distributions of income or capital.

Under the new provisions, if the recipient of the distribution referred to above was also outside the family group of the new test individual (which is a likely result if the recipient was an unrelated arm's length third party), then even though the family trust distribution tax had been incurred and even paid, the fact that there had been a distribution outside the family group is enough to deny the trust the ability to elect a new test individual.

Timing restrictions

The same time period restrictions as apply in relation to the revocation of FTEs described above also apply in relation to the variation of the test individual (s 272-80(7) ITAA36).

Variation of the test individual as a result of a marriage breakdown

Section 272-80(5C) ITAA36 includes additional circumstances in which the test individual may be varied as a result of marriage breakdown. The provisions only require that as a result of an order, agreement or award of the kind mentioned in the CGT marriage breakdown provisions (s 126-5(1)(a)–(f) ITAA97), the new individuals and members of the new individual's family have control of the trust (ss 272-80(5C) and 95D).

Family member and the definition of family

In addition to the above, there are a number of amendments which have been made to Sch 2F ITAA36 by the *Tax Laws Amendment (2007 Measures No. 4) Act 2007* which do provide for some increased flexibility or at least practical solutions to current problems with FTEs.

First, s 272-90(3A) ITAA36 provides that trusts that have made FTEs nominating the same test individual are all within the one family group. This means that the prior practice of making numerous IEEs for trusts all nominating the same test individual can cease. Previously a group of three trusts with the same test individual would require nine elections to ensure that all of the trusts were members of each other's family groups (one FTE and two IEEs in each case).

Second, s 272-90(2A)(a) to (c) ITAA36 now provides that former spouses, widows/widowers, and step-children will remain members of the family group despite changes in the nature of the relationship between the parties — for example, by marriage breakdown or remarriage.

Third, the definition of the "family" of a test individual has also been extended. Section 272-95(1)(c) ITAA36 includes in the definition lineal descendants of the nephew, niece or child of the test individual. Further, s 272-95(3) ITAA36 provides that adopted children, step-children and ex-nuptial children are to be considered when determining the lineal descendants of a member of the family. Finally, s 272-95(2) ITAA36 now provides that a person does not cease to be a member of the family as a result of the death of another member of the family.

Uncertainty in respect of the amendments

Up until September 2008, there was some uncertainty in relation to the above amendments as the new Rudd Labor Government had indicated that they intended to reverse the amendments effective from 1 July 2008.

Consistent with the position taken by the Rudd Labor Government, the Tax Laws Amendments (2008 Measures No. 4) Bill 2008 was inclusive of provisions which reversed the once only ability to vary the test individual nominated in respect of a family trust election and to reinstate the previous definition of "family" for the purposes of the family trust election regime. However, these proposed amendments were subject to a significant amount of controversy and criticism.

Regardless of the position taken by the government, the Tax Laws Amendments (2008 Measures No. 4) Bill 2008 was passed by the Senate subject to the removal of the provisions contained in the Tax Laws Amendments (2008 Measures No. 4) Bill 2008 which sought to reverse some of the recent changes to the family trust election regime. On that basis, all of the amendments included in the *Tax Laws Amendment (2007 Measures No. 4) Act 2007*, as outlined above, remain in force and are effective.

Threshold requirements to make an FTE

In order to make the election, the trust must pass the family control test in s 272-87 ITAA36 at the end of the specified income year (s 272-80).

A trust passes the family control test if a group (generally defined as the test individual, one or more members of the test individual's family or the test individual and one or more members of the test individual's family):

- has the power to obtain, or is capable under a scheme of gaining, beneficial enjoyment (directly or indirectly) of the capital or income of the trust;
- is able to (directly or indirectly), or is capable under a scheme of gaining, control of the application of the capital or the income of the trust;
- is able to appoint or remove the trustee or the trustee of the trust is accustomed, under an obligation or might reasonably be expected to act in accordance with the directions, instructions or wishes of the group;
- has more than a 50% stake in the income or capital of the trust; or
- includes the only persons who under the terms of the trust can obtain the beneficial enjoyment of the income and capital of the trust.

Why make an FTE?

Trust loss measures

Under the trust loss regime family trusts are normally "excepted trusts". Generally, excepted trusts are not required to satisfy any tests in order to claim tax losses and certain debt deductions. Family trusts, however, remain subject to the income injection test (refer to ¶7-135).

In order for a family trust to be an "excepted trust" for the purposes of the trust loss measures, the trust must have made its election to be a family trust before or at the beginning of the income year in which the loss was incurred.

Under the trust loss measures, fixed trusts and non-fixed trusts (if applicable) must satisfy the 50% stake test (refer to ¶7-135). If a family trust has, directly or indirectly, a fixed entitlement to a share of the income or capital of the main entity, the family trust is treated as if it had the fixed entitlement as an individual and for the individual's own benefit (s 272-30(2) ITAA36). This enables the main entity to satisfy the 50% stake test in cases where interests in the main entity are held by a non-fixed trust. In cases where interests in the main entity are held by fixed trusts, the main entity satisfies the 50% stake test without having to trace interests to the ultimate individual.

Entitlement to franking credit benefit associated with a dividend

As a general rule, a beneficiary of a discretionary trust will only be entitled to the franking credit benefit associated with a dividend where the discretionary trust has made an FTE. This is as a result of the requirement that a taxpayer may only claim franking credits if that person is a "qualified person" in relation to the franked dividend. In order to be a qualified person a taxpayer must satisfy two rules:

- the holding period rule; and
- the related payments rule (s 160APHO ITAA36).

Refer to ¶7-110.

Continuity of ownership test for companies

In order to be able to claim tax losses from prior years a company must satisfy either the continuity of ownership test (COT) or the same business test. The same business test will apply only if the company fails the COT.

Broadly, the COT requires that the same persons at all times during the ownership test period beneficially own shares carrying more than 50% of all voting, dividend and capital rights (s 165-12 ITAA97). The ownership test period is the period from the start of the loss year to the end of the income year in which the tax losses are to be applied (s 165-12(1) ITAA97).

There are two tests for determining whether a company has maintained the same owners throughout the ownership test period. These are the primary test and the alternative test. The primary test applies if the alternative test does not apply (s 165-12(5)). The alternative test applies if one or more other companies beneficially owned shares or interests in shares in the company at the beginning of the ownership test period. The primary test also considers "beneficial ownership" of shares (ss 165-150(1), 165-155(1) and 165-160(1)).

Where shares are held by an entity as trustee of a trust, the rules in applying the primary test and alternate test are modified by s 165-207 ITAA97. Section 165-207 ITAA97 provides that shares held by a trustee of a family trust will be deemed to be treated as if they were owned by a single notional entity that is a person including in the circumstance of a change of trustee. Without this modification both the primary test and the alternate test are unlikely to be able to be satisfied.

¶7-135 Trust loss measures

Introduction

Schedule 2F ITAA36 (the trust loss measures) contains various tests for determining whether a trust can deduct its current and prior year tax losses and certain debts. The applicable tests depend on the nature of the relevant trust. The trust loss measures identify various types of trusts including:

- fixed trusts (ordinary fixed trust and widely held fixed trusts);
- non-fixed trusts; and
- family trusts.

Types of trusts

Ordinary fixed trusts

Fixed trusts are divided into ordinary fixed trusts and widely held fixed trusts (unlisted or listed).

A trust is a fixed trust if persons have a fixed entitlement to all of the income and capital of the trust (s 272-65).

A person has a "fixed entitlement to a share of the income or capital" of a trust if they have a vested and indefeasible interest in the share of the income or capital of the trust (s 272-5(1)). In relation to unit trusts in which units are redeemable or further units may be issued, an interest in the income or capital of the trust will not be defeasible where (s 272-5(2)):

- if the units are listed for quotation in the official list of an approved stock exchange, the units may only be redeemed or further units issued at a price at which other units of the same kind in the unit trust are offered for sale on the stock exchange at the time of the redemption or issue; or
- if the units are not listed, the units may only be redeemed or further units issued at a price determined on the basis of the net asset value, according to Australian accounting principles, of the unit trust at the time of the redemption or issue.

Due to the definition of the phrase "fixed entitlement to a share of income or capital" of a trust in s 272-5, most unit trusts will be non-fixed trusts. When determining whether a unit trust is a fixed or non-fixed trust it is necessary to consider not only the redemption and issue provisions of the trust deed but also the variation clause. Where the redemption and issue provisions accord with the requirements of s 272-5(2) but the trustee or unit holders are empowered to vary the provisions, a person would not be taken to have a fixed entitlement to a share of the income or capital of the trust.

Widely held unit trust

A trust is a widely held unit trust if (s 272-105):

- it is a fixed trust that is a unit trust; and
- it is not closely held.

A trust is closely held if:

- an individual has, or up to twenty individuals have, between them; or
- no individual has, or no individuals have between them,

directly or indirectly and for their own benefit fixed entitlements to a 75% or greater share of the income or capital of the trust.

For the purposes of the above definition, all the following are taken to be a single individual (s 272-105(3)):

- an individual (whether or not the individual holds units in the unit trust);
- the individual's relatives; and
- any nominees of the individual or the individual's relatives who hold units.

Non-fixed trusts

A trust that is not fixed, according to s 272-70, is known as a non-fixed trust.

Family trusts

A trust is a family trust at any time when a family trust election in respect of the trust is in force (s 272-75). Refer to ¶7-130.

Tax losses

The trust loss measures apply to tax losses made in prior and current income years. Section 995-1 ITAA97 defines the term "tax loss" to mean losses worked out under various provisions ITAA97. Broadly, where deductions for an income year exceed income, the excess is a tax loss.

The trust loss measures do not apply in respect of capital losses.

Trust loss tests

The trust loss tests applicable to a trust depend on the type of the trust. The relevant trust loss tests must be satisfied during the test period. Generally the "test period" is the period from the beginning of the loss year until the end of the income year in which the tax losses are to be applied.

A fixed trust (other than a widely held unit trust) must satisfy:

- the 50% stake test for the test period (s 266-40) (the fixed trust 50% stake test); or
- the non-fixed trust stake test (s 266-45) if the trust fails to meet the fixed trust 50% stake test (the alternative fixed trust 50% stake test).

A non-fixed trust:

- must satisfy the pattern of distributions test if applicable (s 267-30);
- must not have been prevented from deducting the tax loss in an earlier income year because of a failure to meet the pattern of distributions test (s 267-35);
- in which there are individuals having more than a 50% stake in the income or capital of the trust must maintain the same ownership (s 267-40) (the non-fixed trust 50% stake test); and
- must not begin to be controlled by a group directly or indirectly during the test period (s 267-45) (the control test).

Fixed trusts and non-fixed trust (including family trusts) must satisfy the income injection test.

A listed widely held trust must pass the same business test (s 269-100).

Excepted trusts are not required to satisfy any tests excepting family trusts which must satisfy the income injection test (s 270-10(1)(d)). A trust is an excepted trust at a particular time if (s 272-100):

- it is a family trust;
- it is a complying superannuation fund or approved deposit fund;

- it is a trust of a deceased estate (but only for a period of five years after the death of the individual); or
- it is a unit trust in which fixed entitlements to the income and capital of the trust are held directly or indirectly by exempt entities.

The fixed trust 50% stake test (Subdiv 269-C)

If there are individuals who have between them directly or indirectly and for their own benefit fixed entitlements to a greater than 50% share of the income or capital of a trust, those individuals have "more than a 50% stake in the income or capital of the trust" (s 269-50).

The concept of a "fixed entitlement" is discussed above in respect of ordinary fixed trusts. In addition, a person holds a fixed entitlement to a share of income or capital of a company, partnership or trust indirectly if the person holds the entitlement indirectly through fixed entitlements in interposed entities (s 272-20). Sections 272-25 and 272-30 include special cases of fixed entitlements held directly or indirectly. Entities that are treated as having as individuals and for their own benefit directly or indirectly a fixed entitlement to a share of the income or capital of a company, partnership or trust include:

- certain government bodies and special companies (defined in s 272-140);
- complying superannuation funds, approved deposit funds and certain foreign superannuation funds;
- family trusts; and
- interposed listed public companies and widely held unit trusts in some cases.

A trust will pass the 50% stake test if (s 269-55(1)):

- at all times during a period; or
- at two times;
- the same individuals have more than a 50% stake in the income of a trust; and
- the same individuals (who may be different from those having more than a 50% stake in the income) have more than a 50% stake in the capital of the trust.

A widely held unit trust passes the 50% stake test if it is reasonable to assume that the requirements in s 269-55(1) have been satisfied (s 269-55(2)).

The alternative fixed trust 50% stake test (s 266-45)

If a fixed trust fails to meet the fixed trust 50% stake test then the trust must satisfy the following conditions at all times during the test period:

- non-fixed trusts (other than family trusts) must have held fixed entitlements to a 50% or greater share of the income or capital of the trust; or
- both a fixed trust or a company (the holding entity) must have held directly or indirectly all of the fixed entitlements to income and capital of the trust; and
- non-fixed trusts (other than family trusts) must have held fixed entitlements to a 50% or greater share of the income or capital of the holding entity;

- the persons holding fixed entitlements to the shares of income and capital of the trust or holding entity must have held those entitlements at all times during the test period;
- at the beginning of the test period individuals must not have had more than a 50% stake in the income or capital of the trust; and
- each non-fixed trust (other than an excepted trust) that at any time in the test period held directly or indirectly a fixed entitlement to a share of the income or capital of the trust must satisfy the non-fixed trust 50% stake test (if applicable), the pattern of distributions test (if applicable) and the control test.

The non-fixed trust 50% stake test

This test is the same as the fixed trust 50% stake test. However, it is difficult to conceive a situation where the 50% stake test would apply to a non-fixed trust.

Pattern of distributions test

The pattern of distributions test will only apply where a non-fixed trust has distributed income and/or capital in the income year in which the tax loss is to be applied or within two months after the end of the income year, and in at least one of the six earlier income years.

The pattern of distributions test is the most difficult test to satisfy. It considers whether there has been an effective change in those who benefit under the trust. The test compares trust distributions of income or capital of the year in which the tax losses are applied and all relevant previous income years. The trust will only pass the pattern of distributions test if it has not failed this test in relation to the tax loss in a previous income year.

The test considers distributions made either directly or indirectly to individuals and therefore may require tracing of distributions to the ultimate individual recipient where there are entities interposed between the trust and the individual.

A trust passes the pattern of distributions test for an income year if within two months after the end of the income year, the trust distributed, either directly or indirectly, to the same individuals, for their benefit, a greater than 50% share of all test year distributions of income and capital (s 269-60). The distributions of income and capital may be made to different individuals.

A "test year distribution of income or capital" is the total of all income or capital distributions made by a non-fixed trust in any of the following periods (s 269-65), provided the period does not start more than six years before the start of the income year in which the tax loss is to be applied:

(1) the start of the income year (in which the losses are applied) until two months after its end;

(2) if the trust distributed income before the loss year (trigger year) the closest year of income before the trigger year;

(3) if point 2 does not apply and the trust distributed income in the trigger year, the trigger year;

(4) if neither point 2 nor point 3 applies, the income year closest to the trigger year in which the trust distributed income;

(5) each intervening year between the one in point 1 and the one in either points 2, 3 or 4.

If the trust does not distribute to an individual the same percentage of income or capital for every test year distribution, then the trust is taken to have distributed to the individual for every test year distribution, the smallest percentage that it distributed to the individual for any of the test year distributions (s 269-70).

Control test

A group must not during the test period begin to control the trust directly or indirectly (s 267-45). If the trust is controlled by a group prior to the commencement of the test period and continues to be controlled by that group throughout the test period, then the control test would not be breached.

A group controls a non-fixed trust if (s 269-95(1)):

(1) the group has the power to obtain beneficial enjoyment directly or indirectly of the capital or income of the trust;

(2) the group is able directly or indirectly to control the application of the capital or income of the trust;

(3) the group is capable under a scheme of gaining the beneficial enjoyment in point 1 or the control in point 2;

(4) the trustee is accustomed, under an obligation or might reasonably be expected to act in accordance with the directions, instructions or wishes of the group;

(5) the group is able to remove or appoint the trustee; or

(6) the group acquires more than a 50% stake in the income or capital of the trust.

A "group" is defined as (s 269-95(5)):

- a person;
- a person and one or more associates; or
- two or more associates of a person.

Depending on the terms of the trust deed, the control test may be breached where there is a change in unit-holding percentages in a unit trust or a change in the trustee or in the case of a discretionary trust, a change in the appointor.

The same business test

The same business test is an alternative test that applies if a listed widely held trust fails the 50% stake test (due to abnormal trading in units). If there is abnormal trading the trust must pass the 50% stake test at the beginning of the test period and immediately after the abnormal trading (s 266-125(1)). If it fails the 50% stake test then at all times after the first abnormal trading and before the end of the test period the trust must pass the same business test in relation to the time before the abnormal trading (s 266-125(2)).

A listed widely held trust passes the same business test during a period (the same business test period) in relation to a time (the test time) if throughout the same business test period it carries on the same business as it carried on immediately before the test time.

However, the trust will not pass the same business test in any of the following cases:

- if at any time during the test period it derives assessable income from a business of a kind that it did not carry on before the test time or a transaction of a kind that it had not entered into in the course of its business operations before the test time;
- if before the test time it started to carry on a business it had not previously carried on or in the course of its business operations entered into a transaction of a kind that it had not previously entered into and did so for the purpose or purposes including that of being taken to have carried on throughout the same business test period the same business as it carried on immediately before the test time; and
- if at any time during the same business test period it incurs expenditure in carrying on a business of a kind that it did not carry on before the test time or as a result of a transaction of a kind that it had not entered into in the course of its business operations before the test time.

Income injection test

The income injection test applies to fixed and non-fixed trusts. However excepted trusts (other than family trusts) do not need to satisfy the test. Broadly, the income injection test deals with schemes by which income is injected into trusts with tax losses or other deductions so that the tax payable on the income is reduced or eliminated.

Pursuant to s 270-10, the test will apply where:

- the trust has an allowable deduction; and
- there is a scheme under which the following happened:
  - the trust derives an amount of assessable income (scheme assessable income) in the income year;
  - an outsider to the trust directly or indirectly provides a benefit to either the trustee or beneficiary of the trust or an associate of either (the benefit may constitute all or any of the scheme assessable income);
  - the trustee or beneficiary or associate thereof either directly or indirectly provides a benefit to the outsider of the trust or an associate of the outsider (the benefit may constitute all or any part of the deduction); and
- it is reasonable to conclude that either:
  - the trust derived the scheme assessable income;
  - the outsider provided the benefit; or
  - the trustee, beneficiary or associate thereof provided the benefit,

  wholly or partly but not merely incidentally because the deduction would be allowable (s 270-10(1)).

Broadly, where the conditions in s 270-10(1) are satisfied, no deduction is allowable against the scheme assessable income in the income year being examined, with the result that the net income of the trust for income year is increased to equal to the full amount of the scheme assessable income (s 270-15). The tax loss to which the deduction relates continues to be carried forward and may be applied against the trust's ordinary assessable income in future income years.

An outsider to trust other than a family trust is any person other than the trustee of the trust or any person with a fixed entitlement to a share of the income or capital of trust (s 270-25(2)).

An outsider to a family trust is a person other than (s 270-25(1)):

- the trustee of the trust;
- a person with a fixed entitlement to a share of the income or capital of the trust;
- the individual specified in the trust family election (the test individual);
- a member of the test individual's family;
- a company, partnership or trust that made an interposed entity election to be included in the test individual's family group;
- a trust that has made family trust election nominating the same test individual the family trust; or
- a fixed trust, partnership or company (the entity) where at all time while the scheme was being carried out, the test individual or one or more members of the test individual's family or the trustees of one or more family trusts having the same test individual as the trust, or any combination thereof, had fixed entitlement directly or indirectly for their own benefit to all of the income and capital of the entity.

Income derived by a trust on commercial and/or arm's length terms or as an existing beneficiary of another trust, generally would not constitute scheme assessable income.

¶7-140 Trustee beneficiary statements and TFN withholding for closely held trusts

The primary purpose of the closely held trust provisions is to prevent the avoidance or deferral of tax liabilities through the use of arrangements involving complex chains of trusts which potentially obscured the identity of the ultimate beneficiary of assessable trust income. Briefly, a closely held trust is defined in s 102UC ITAA36 and is:

- a trust where an individual has, or up to 20 individuals have between them, directly or indirectly, and for their own benefit, fixed entitlements to a 75% or greater share of the income or capital of the trust; or
- a discretionary trust,

but excluding "excluded trusts". The definition of "excluded trusts" in s 102UC(4) ITAA36 includes complying superannuation funds, complying approved deposit funds, pooled development funds, deceased estates or fixed trusts where exempt entities have fixed entitlements. Importantly, the exclusion also extends to trusts covered by a family trust election, those with an interposed entity election or wholly owned by the family trust or family group.

The Commissioner is also authorised pursuant to s 102UK(1A) and 102UK(1B) ITAA36 to determine that a specified class of trustee will not be required to comply with the annual reporting obligations.

Prior to amendments made to the closely held trust provisions contained in Pt III, Div 6D ITAA36 by the *Tax Laws Amendment (2007 Measures No. 4) Act 2007*, the *Taxation (Trustee Beneficiary Non-disclosure Tax) Act (No. 1) 2007* and the *Taxation (Trustee Beneficiary Non-disclosure Tax) Act (No. 2) 2007* the trustee of a closely held trust was required to provide the Commissioner with what is known as an ultimate beneficiary statement (UBS) which discloses the identity of the ultimate beneficiaries in relation to the closely held trust's net income and tax preferred amounts.

To comply with the reporting provisions, the trustee of a closely held trust was required to trace distributions of income through trustee beneficiaries to the ultimate beneficiaries. Failure to comply with the legislation resulted in a liability to pay ultimate beneficiary non-disclosure tax in accordance with s 102UK(2) ITAA36.

The exercise of identifying and tracing the ultimate beneficiaries of a closely held trust was an onerous task with significant penalties for failure to comply. In response to concerns associated with the onerous nature of preparing and lodging a UBS, PS LA 2001/12 was issued in 2001 which provided that the Commissioner would be exercising his discretion to extend the UBS lodging period.

New provisions

Division 6D was amended by the *Tax Laws Amendment (2007 Measures No. 4) Act 2007*, the *Taxation (Trustee Beneficiary Non-disclosure Tax) Act (No. 1) 2007* and the *Taxation (Trustee Beneficiary Non-disclosure Tax) Act (No. 2) 2007*. There are three significant changes to the closely held trust provisions as a result of the amending legislation. The first is the removal of reporting at the ultimate beneficiary level and its replacement with reporting at the trustee beneficiary level which is considered in detail below. The second is the exclusion of specified trusts from the provisions. The third is the introduction of the concept of "untaxed part", resulting in the closely held trust provisions applying only to the untaxed part of a distribution.

The amendments to the closely held trust provisions apply to the first income year starting on or after the date on which the amending legislation received royal assent, being 24 September 2007.

Trustee beneficiaries v ultimate beneficiaries

The amending legislation introduces what are known as trustee beneficiary statements (TBS) which replace the UBS and result in the reporting requirements in relation to closely held trusts being limited to trustee beneficiaries. A trustee beneficiary is an entity which is a beneficiary of a trust (the closely held trust) in its capacity of trustee of another trust. The TBS will be required to be lodged in respect of each trustee beneficiary to whom a distribution of trust income is made by a closely held trust.

The removal of reporting at the ultimate beneficiary level significantly reduces the reporting obligations imposed on the trustee of a closely held trust and eliminates to some extent what was previously seen as multiple reporting in respect of the same income.

For example, if the trustee of a closely held trust had distributed income to a beneficiary which was a discretionary trust (trustee beneficiary) which in turn distributed that income or part of that income to two beneficiary trusts or other entities (ultimate beneficiaries), depending on the facts, a UBS would potentially have been required in respect of all three trusts, on the basis that there are distributions to two ultimate beneficiaries and the distribution to the trustee beneficiary would also result in the trustee beneficiary being considered an ultimate beneficiary. Under the new provisions a TBS would be completed only in respect of the trustee beneficiary.

The broad structure of the closely held trust provisions has been retained in that failure to comply with the provisions will result in the imposition of trustee beneficiary non-disclosure tax, being a liability to pay tax on the income distributed to the trustee beneficiary at the highest marginal rate. Further, there is no change to the time within which the TBS must be lodged as compared to the UBS, and the discretion of the Commissioner to alter the lodging period has not been removed. The Commissioner's discretion to alter the lodging period is acknowledged on the ATO website, which includes an example of where the Commissioner may exercise his discretion. The example given, although not a definitive indication of where the discretion will be exercised, includes the circumstance of a taxpayer being unable to lodge the TBS within the prescribed time period as a result of a failure by a third party to provide information necessary to complete lodgment of the TBS. Further, perhaps as an indication of the Commissioner's position in respect of the operation of the new provisions, reference is made on the ATO website to practice statements introduced during the operation of the old provision as relevant to completion and lodgment requirements.

Concept of untaxed part

By virtue of the removal of ss 102UE and 102UF ITAA36 and the introduction of a definition of "untaxed part" in s 102UE ITAA36 and the repeal of s 102UG ITAA36 and replacement with a new s 102UG, the trustee of a closely held trust will not be required to report amounts in a TBS to the extent that those amounts have been taxed to the trustee of the closely held trust, or to an earlier trustee in the chain. The aim of these amendments is to reduce unnecessary reporting and the prospective of double taxation as it is only the untaxed portion of any distribution that the Commissioner is concerned with.

Under the new provisions, a trustee of a closely held trust will not be required to complete a TBS in respect of any share of income which is specified in s 102UE(2) ITAA36. This includes where the following apply:

- the trustee of a closely held trust is assessed and liable to pay tax under s 98(4) ITAA36 in respect of the share;
- the share is reasonably attributable to a part of the net income of another trust estate in respect of which the trustee of the other trust estate is assessed and liable to pay tax under s 98(4) ITAA36;
- the share is represented by or reasonably attributable to an amount from which an entity was required to withhold an amount under Sch 1, Subdiv 12-H of the *Taxation Administration Act 1953*; or
- the share is reasonably attributable to a part of the net income of another trust estate in respect of which the trustee of the other trust estate was liable to pay trustee beneficiary non-disclosure tax.

In addition to the amendments to the reporting provisions, there are provisions which impose penalty tax in specific circumstances. For example, where a distribution flows through a chain of trusts back to the originating trust, tax is payable on the untaxed amount of income at 46.5%.

TFN withholding for closely held trusts

On 28 June 2010, the *Tax Laws Amendment (2010 Measures No. 2) Act 2010* received royal assent. Schedule 2 of the *Tax Laws Amendment (2010 Measures No. 2) Act* 2010, which has effect from 1 July 2010, inserts a new Div 4B immediately after Pt VA, Div 4A ITAA36 and amends Sch 1, Ch 2, Pt 2-5 of the *Taxation*

Administration Act 1953 to impose new obligations in relation to the quotation of tax file numbers in respect of certain closely held trusts.

Trusts subject to the new TFN withholding rules

The new provisions included both in the ITAA36 and the *Taxation Administration Act 1953* as a result of the *Tax Laws Amendment (2010 Measures No. 2) Act 2010* apply to the trustee of a trust and a beneficiary of a trust if:

- the trust is (s 12-175(1)(c) of the *Tax Laws Amendment (2010 Measures No. 2) Act 2010)*:
  - a resident trust estate (within the meaning of s 95(2) ITAA36) in the income year; and
  - a closely held trust (within the meaning of s 102UC ITAA36, disregarding paras (c), (d) and (e) of the definition of "excluded trust" in s 102UC(4) ITAA36) (referred to in this chapter as a qualifying trust).
- the beneficiary is (s 12-175(1)(d) of the *Tax Laws Amendment (2010 Measures No. 2) Act 2010)*:
  - an Australian resident;
  - not an exempt entity (as that term is defined in s 995 ITAA97); and
  - not under a legal disability for the purposes of s 98 ITAA36.

The modification to the definition of "excluded trusts" by the deletion of paras 102UC(4)(c), (d) and (e) of the *Taxation Administration Act 1953* means that the usual exclusion from the reporting requirements of closely held trusts that have made family trust elections or interposed entity elections or which are wholly owned by the family trust or family group do not apply. These types of closely held trusts are also required to comply with the new tax file number reporting and withholding rules.

It is an offence under s 8C of the *Taxation Administration Act 1953* to fail to report a quoted TFN to the Commissioner.

New TFN reporting rules — Pt VA Div 4B ITAA36

The new Pt VA, Div 4B ITAA36 imposes new obligations on trustees in relation to the reporting of the tax file numbers of beneficiaries. Trustees will be required to lodge with the Commissioner, in the approved form, and within one month after the end of the quarter to which the report relates, or such further time as the Commissioner allows, the tax file number of beneficiaries where:

- the beneficiary has quoted their tax file number to the trustee during the quarter (s 202DP(1)(a)); and
- the beneficiary has not quoted the tax file number to the trustee in connection with an investment to which Pt VA applies (s 202DP(1)(b)); and
- the trustee has not reported and is not required to report the beneficiary's tax file number to the Commissioner pursuant to Pt III, Div 6D ITAA36 (s 202DP(1)(c)).

The explanatory memorandum to the Tax Laws Amendment (2010 Measures No. 2) Bill 2010 at para 2.12 indicates that the trustee is only required to report the quoted tax file number once. The TFN report must include the beneficiary's TFN, full name, date of birth (for individuals only), postal address, business or residential address, entity type, and Australian business number (ABN) if a non-individual beneficiary.

New TFN reporting rules — Taxation Administration Act 1953

The new ss 12-175 and 12-180 in Sch 1 of the *Taxation Administration Act 1953*, require the trustee of a closely held trust to withhold an amount from payments made to beneficiaries where the relevant beneficiary has not provided their TFN to the trustee.

The provisions apply if:

- the trustee of a closely held trust has made a distribution to a beneficiary where some or all of the distribution is from the ordinary income or statutory income of the closely held trust (s 12-175(1) of the *Taxation Administration Act 1953*); and
- a beneficiary of the trust is presently entitled, for the purposes of Pt III, Div 6 ITAA36 to a share of the income of the trust for that year (s 12-180 of the *Taxation Administration Act 1953*). The amount withheld will equal the top tax rate plus Medicare levy. If an amount has been withheld, an annual TFN withholding report must be lodged with the ATO at the end of the income year. Certain payments are excluded from the TFN withholding rules, including where:
  - a trustee is liable to pay tax under s 98 ITAA36 in connection with the distribution (s 12-175(2)(b)) of the *Taxation Administration Act 1953*);
  - a trustee is required to make a TBS under Pt III, Div 6D ITAA36 in connection with the distribution (s 12-175(2)(c)) of the *Taxation Administration Act 1953*); or
  - family trust distribution tax is payable under Sch 2F ITAA36 in connection with the distribution (s 12-175(2)(d)) of the *Taxation Administration Act 1953*).

See also other excluded payments detailed in the ATO guide "TFN withholding for closely held trusts", as well as transitional arrangements for the 2010-11 income year.

End to transitional arrangements for TFN withholding for closely held trusts

The transitional TFN reporting arrangements enacted by *Tax Laws Amendment (2010 Measures No 2) Act 2010* which enabled a trustee to lodge a TFN report for the 2010-11 income year when lodging the trust's 2011 income tax return ended on 1 July 2011. New reporting requirements applied from 1 July 2011 onwards.

The transitional TFN reporting arrangements had allowed for:

- the 2010 trust return to be taken as a TFN report; and
- extended due dates for the lodgment of quarterly TFN reports for 2010-11.

Trustees of closely held trusts must lodge a TFN report by the end of the month following the quarter in which any new TFNs are notified to the trustees. Where those TFNs are only notified to the trustees prior to year end resolutions, then 31 July becomes the key date for the making of the TFN report. Tax file number reports must be lodged for each beneficiary to whom a "payment" was made. "Payment" includes both a distribution of ordinary or statutory income of the trust and a beneficiary's share of the net income of the trust where the beneficiary became presently entitled to a share of trust income (ss 12-175 and 12-180 of Sch 1 of the *Taxation Administration Act 1953*).

When does the obligation to make a TFN report arise?

The obligation for a trustee to report a beneficiary's TFN is a "once only obligation", with a TFN report only being required to be lodged if new TFNs are quoted to the trustee.

Importantly, this test operates on a trustee by trustee basis as opposed to a family group basis. Therefore, a change in the distribution pattern within a family group may necessitate trustees reporting the TFNs of beneficiaries that may have previously been reported by other trustees within the family group.

Trustees will only need to lodge TFN reports for beneficiaries who did not receive payments in the 2010-11 income year, provided that the required details for all other beneficiaries were included in the 2011 trust tax return. As noted above, the 2011 trust tax return is treated as a TFN report under the transitional measures. It is advisable to lodge TFN reports for any beneficiary who may receive a payment in the future.

The TFN report must be lodged by trustees by the last day of the month following the end of the quarter in which the TFN was quoted by the beneficiary to the trustee. For example, the TFN reportmust be lodged by 31 July if the TFN was quoted to the trustee during the quarter ended 30 June (s 202DP(2) ITAA36).

Pursuant to s 8E(1) of the *Taxation Administration Act 1953*, a failure to report this information to the Commissioner is an offence under s 8C of that Act, with a fine of up to 20 penalty units ($2,200) for a first offence.

What must the TFN report contain?

The TFN report must include the beneficiary's:

- TFN;
- full name;
- date of birth (individuals only);
- postal address;
- business or residential address;
- entity type; and
- ABN (if applicable).

What are the notification requirements?

It is advisable that a beneficiary notify the trustee of their TFN verbally or in writing before a payment (appointment or distribution) is made to them.

If a beneficiary does not do so, the trustee is obliged to withhold tax on that payment at the rate of 46.5%. The trustee is then required to apply for PAYG withholding, and must lodge an annual TFN withholding report for the relevant financial year by 30 September. The beneficiary can claim a credit in their income tax return for any amounts withheld.

¶7-145 Tax deductibility of interest incurred to acquire an interest in a trust

Section 8-1(1)(a) ITAA97 provides that a loss or outgoing can be deducted from assessable income to the extent that it is incurred in gaining or producing assessable income. This is commonly referred to as the "first limb" and will more usually be the relevant provision in considering the deductibility of interest incurred on funds borrowed to acquire interests in trust structures. Alternatively, s 8-1(1)(b) ITAA97 provides that a loss or outgoing may also be deducted from assessable income if it was necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

When is a loss incurred in gaining or producing assessable income?

When determining whether a loss or outgoing has been incurred in producing assessable income, the courts have generally applied an "objective" test in looking at the totality of the transaction rather than looking to the actual intent of the taxpayer in question. There is, however, a preparedness to look at the intent of the individual taxpayer in certain cases. This position was outlined in the High Court decision in *Fletcher v FCT* 90 ATC 4559 *(Fletcher's* case*)* and principally applies to the circumstance of where no relevant assessable income can be identified in respect of an outgoing.

Is interest incurred deductible?

Whether interest incurred is deductible will depend, to a substantial extent, on the use to which the borrowed money is put; that is, the purpose for which the money was borrowed. This is consistent with the determination of the Federal Court in *Ure v FCT* 81 ATC 4100. In this case it was said that:

> *… an outgoing of interest may be incidental and relevant to gaining assessable income where the borrowed money is laid out for the purpose of gaining that income … The laying out of the borrowed money for the purpose of gaining assessable income furnishes the required connection between the interest paid upon it by the taxpayer and the income derived by him from its use.*

Acquisition of an interest in a unit trust

One of the common circumstances in which a taxpayer may borrow money to acquire an interest in a trust is in the acquisition of units in a unit trust. Those funds are in turn used by the trustee of the unit trust in the acquisition of assets or the conduct of a business. A unit trust used for this purpose normally provides that the trust property is notionally divided into a specified number of units and that each of those units confers on the holder of them an entitlement to the proportionate share of the income and capital of the trust fund as that single unit represents to the total number of units in the trust.

Assuming that only ordinary units have been issued, the entitlement to a deduction for the interest incurred by a unitholder on funds borrowed to purchase the units will depend on the application of the law established in *Fletcher's* case. It will not be fatal to the deductibility of the interest if the investment does not immediately produce assessable income of a corresponding or greater amount. The reference to assessable income in s 8-1 ITAA97 includes assessable income that the investment might be expected to produce in future years.

However, there are additional factors which need to be considered when determining whether interest will be deductible. It was expressed by the High Court in the case of *Steele v FCT* 99 ATC 4242 that it is possible for an outgoing to be entirely preliminary to the gaining or producing of assessable income so that there is not a sufficient connection between the incurring of the outgoing and the actual or projected receipt of income for it to be deductible.

IT 2684 has considered the issue of deductibility of interest incurred in acquiring an interest in a unit trust; however, it relates specifically to split property unit trusts. For the purposes of IT 2684, “split property unit trust” is a reference to a property unit trust which offers investors a choice between income units, growth units or combined units. Income units are those which offer a return consisting substantially of income rather than capital growth, while growth units offer substantially capital growth with less income.

The ruling states that interest expenses incurred on borrowed funds used to purchase income, growth or combined units in a split property unit trust are generally an allowable deduction — even if the amount of the interest incurred is greater than the amount of the assessable income derived from the units for the particular income year, except in some specified instances where it is stated that an apportionment of the interest expense is necessary. Those situations include:

- where only negligible income is produced by growth units, in which case the interest may only be deductible up to the extent of the assessable income; and
- where the expected return from the units, both income and capital growth, does not provide an obvious commercial explanation for incurring the interest, especially if the amount of assessable income expected is disproportionately less than the amount of interest expense.

Until recently, significant uncertainty surrounded whether the Commissioner’s view as expressed in IT 2684 applies to all entities, including for example ordinary unit trusts, or whether it is limited to split property unit trusts. Arguably, when determining the deductibility of interest, it is necessary to consider s 8-1 ITAA97 and the relevant case law which provides that an assessment must be made in each case as to whether the interest has been incurred in gaining or producing assessable income, or been necessarily incurred in carrying on a business for the purposes of gaining or producing assessable income.

Acquisition of an interest in a hybrid trust

The issue of deductibility of interest on money borrowed to acquire interests in trusts of a more complex nature, for example “hybrid trusts” which incorporate discretionary features, also needs to be considered.

There are a number of different ways in which a “hybrid trust” can be structured, each providing the interest holders with different rights. Determining the rights of the unitholders and discretionary beneficiaries of a hybrid trust is something that will need to be considered by reference to the trust deed of every trust. The following considers the application of s 8-1 ITAA97 and the relevant case law when determining the ability to deduct interest incurred on money borrowed to acquire an interest in a hybrid trust.

Unit trust with classes of beneficiaries capable of receiving both income and capital

Briefly, this type of hybrid trust (class income unit trust) is a unit trust which also has a class or classes of discretionary beneficiaries, commonly with one class for each unitholder (refer to ¶3-130). The unitholders are entitled to their proportionate share of both income and capital except that the trustee has the discretion to distribute all or part of the income to the class or classes of beneficiaries (and as between the members of those classes, in such shares as the trustee determines). The trustee also has the discretion to distribute capital to the classes of beneficiaries in the same way.

Save for where a taxpayer has effective control, the discretion of the trustee of a trust in relation to the distribution of income means that a taxpayer does not have an absolute right to any trust income. It is therefore necessary to consider whether interest incurred on money borrowed by the unitholder to acquire the units in a hybrid trust of this kind is deductible. The question is whether "it is incurred in gaining or producing" assessable income as required by s 8-1(1)(a).

Even if the income is received by a unitholder and it exceeds the amount of the interest outgoings, it may be that the interest was not incurred for the purpose of gaining that income where the income was received only because the trustee elected not to exercise the discretion to distribute the income to the classes of beneficiaries. If the unitholder has no absolute right to the income, it is necessary to determine whether the receipt of income in this circumstance is any different in nature to the receipt of income from a purely discretionary trust where that is a consequence of the exercise of the discretion of the trustee or as a result of being a default beneficiary. Arguably there is not a sufficient nexus between the incurring of the interest expense and the receipt of the income for it to be said that the interest was "incurred in gaining or producing" the income on the basis that the units do not carry a right to any income. That reasoning would apply whether the income received was greater or lesser than the amount of the interest.

Could Pt IVA apply?

For Pt IVA to apply, s 177D ITAA36 provides that a taxpayer must obtain a tax benefit in connection with the scheme. Relevantly, a tax benefit will be taken to be obtained by a taxpayer in connection with a scheme:

- where an amount has not been included in the assessable income of a taxpayer if the amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or
- where there has been an allowable deduction to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out (s 177C ITAA36).

The entitlement to the interest deduction will stand or fall on whether it is within the scope of s 8-1(1)(a) ITAA97. If the structure results in some party other than the borrower/taxpayer receiving the benefit of a capital gain, there is still no tax benefit by way of reduction in income or increase in deductions available to the taxpayer/borrower. The other party would receive that benefit as a consequence of their interest in or entitlement under the trust structure and will have the liability for any capital gains tax arising.

ATO position

Until recently, the assessment of the deductibility of interest incurred to acquire an interest in a unit trust pursuant to s 8-1 ITAA97 was one which first required an assessment of the rights of the unitholders of the relevant trust and in light of those rights, whether the requisite purpose as required by s 8-1 and the principles established in the relevant cases were established such that the interest expense incurred was deductible.

Although these principles still apply, the release by the Commission of TA 2008/3 on 26 March 2008 and subsequently TD 2009/17 on 15 July 2009 mean that further consideration needs to be given to the issue of deductibility of interest incurred to acquire an interest in a trust, and particularly in relation to unit trusts.

TA 2008/3: Uncommercial use of certain trusts

TA 2008/3 was released by the Commissioner on 26 March 2008. TA 2008/3 is relevant to the issue of determining the deductibility of interest incurred and identifies features of trust arrangements which are of concern to the Commissioner. These arrangements include but are not limited to the following:

> *2. … the taxpayer and his or her associates are beneficiaries of the trust or may become beneficiaries at a future date. The trust deed confers, or can confer in the future, interests or entitlements upon the taxpayer's associates for less-than-market-value consideration …*
>
> *3. … the deed may provide the taxpayer with an entitlement to income or capital which appears fixed, but which can be defeated by the trustee exercising a discretion to distribute income and/or capital gains to other beneficiaries …*
>
> *4. … the trust deed may provide for, or enable, the issue of units or other interests to the taxpayer's associates for no consideration, or for consideration which falls short of the market value of such interests at the time of issue.*
>
> *…*
>
> *6. The trustee uses the funds subscribed by the taxpayer to purchase income producing assets (eg rental property). The assets may be used as security for the taxpayer's borrowings, even though the borrowings are in the taxpayers own name.*
>
> *…*
>
> *9. Beneficiaries other than the taxpayer may, or may not, be entitled to trust income derived over the life of the investment. Where they are, the taxpayer's proportionate share of that income may be smaller than the proportion of the trust's capital which they funded using the borrowed money. In effect, this means that a proportion of the borrowed money is used to fund the production of income for other beneficiaries.*
>
> *…*
>
> *11. Having regard to the circumstances, it may be expected that the taxpayer's interest in the trust will be brought to an end before their costs of investment have been recouped. This may occur, either by:*
>
> *(a) the trustee exercising a discretion which effectively defeats the taxpayer's right to a share of the income of the trust; and/or*
>
> *(b) the issue of further interests in the trust to other beneficiaries; and/or*
>
> *(c) the redemption or extinguishment of the taxpayer's interest in the trust.*

12. *Typically, the deed purports to deny the taxpayer any interest in capital gains of the trust, or the proportionate share of capital gains to which the taxpayer is entitled is smaller than the proportion of the trust's capital which they funded using borrowed money. This is achieved by:*
    - (a) *preventing or restricting the distribution of capital gains to the taxpayer; and/or*
    - (b) *enabling the taxpayer's interest in the trust to be redeemed at face value, or face value, adjusted for inflation.*

Although the taxation alert is not binding, it does provide some guidance as to the position of the Commissioner in relation to the issue of the ability to obtain a deduction for interest incurred on borrowed funds and the various different kinds of trust structures.

TD 2009/17

TD 2009/17 (which finalised TD 2008/D16) was released by the ATO on 15 July 2009. In addition to TD 2009/17, the ATO has also released ruling compendium to TD 2009/17, TD 2009/17EC.

The taxation determination considers the deductibility of interest incurred on funds used by a borrower to acquire an interest in a trust which ultimately may result in benefits being provided to the borrower and other interest holders in the trust. That is, the taxation determination is focused on the principle that a loss or outgoing will not be deductible where it is incurred to gain or produce benefits for other persons.

There are a number of examples included in the taxation ruling which are of assistance when determining whether a loss or outgoing incurred in respect of an interest in a trust will be deductible. These circumstances involve the taxpayer not reasonably being entitled to expect all of the benefits associated with the loss or outgoing incurred and include where, as a result of the provisions of the trust deed the taxpayer:

- is only entitled to trust capital gains;
- is not entitled to trust capital gains;
- is only entitled to part of the trust's income; or
- the units are redeemable at a price which does not reflect the unrealised profits of the trust.

The emphasis in the taxation determination in relation to the determination of the deductibility of interest is that it will usually follow objectively from the terms of the trust deed as to whether an interest expense is for the benefit of others and therefore not deductible. Further, paras 43 to 45 of the taxation determination are relevant to determining the apportionment of an interest expense. The Commissioner at para 43 makes it clear that the determination of the apportionment will be "… essentially a question of fact …". This is further emphasised in the ruling compendium where at issue number 15 the Commissioner states in relation to the issue that "[t]he application of section 8-1 of the ITAA97 in the circumstances of each case is very much a matter of fact and degree …".

Other than the above statements, very little guidance is provided in relation to the issue of apportionment of an interest expense incurred in relation to the acquisition of an interest in a trust where the discretion of the trustee of a trust is involved in the appointment of the income of a trust.

However, regardless of the release of TA 2008/3 and TD 2009/17, the determination of the deductibility of interest incurred on borrowings to acquire an interest in a trust is by no means a simple task. It requires careful consideration of the arrangement in question, including the type of trust interests involved, the entitlements of the taxpayer to the income and capital of the trust and the terms of the trust instrument. Ultimately, TD 2009/17 makes it clear that the entitlements of the taxpayer to the income and capital of the trust and the terms of the trust instrument are paramount to the determination of deductibility of a loss or expense incurred.

¶7-150 Investments in trusts by superannuation funds

The investment by the trustee of a superannuation fund in trusts, especially unit trusts, has been restricted since 11 August 1999 when the definition of an in-house asset in the *Superannuation Industry (Supervision) Act 1993* (SISA) and the *Superannuation Industry (Supervision) Regulations 1994* (SISR) was expanded to include an investment in a "related trust". This, combined with the non-arm's length income provisions in the ITAA97 (formerly known as the special income rules in the ITAA36), has led to a common perception that superannuation funds cannot hold an interest in a trust.

This common perception is incorrect as there are many circumstances in which a superannuation fund can hold an interest in a trust, although as with most dealings by superannuation funds any investment by a superannuation fund in a trust must satisfy strict criteria. Briefly, these include: the investment strategy requirements in s 52(2)(f) SISA; the sole purpose test in s 62 SISA; the prohibition against acquiring assets from a related party in s 66 SISA; the arm's length dealing requirements in s 109 SISA; the prohibition against charging an asset of the fund in reg 13.14 SISR; and the public trading trust rules in Pt III, Div 6C ITAA36.

In addition to the above strict criteria, the in-house asset provisions are a significant precondition to a superannuation fund being permitted to acquire an interest in a trust.

Categories of trusts in or from which a superannuation fund may hold an interest or receive a distribution

Subject to the satisfaction of certain conditions, the following are categories of trusts in or from which a superannuation fund may hold an interest or receive a distribution:

- a bare trust;
- a fixed trust;
- a unit trust;
- a discretionary trust; and
- a hybrid trust.

In-house asset provisions

Since 11 August 1999, a superannuation fund has only been permitted to acquire an interest in a trust if the interest acquired would not be an in-house asset within the meaning of s 71(1) SISA (unless the value of the in-house assets of the fund comprises less than 5% of the value all of the assets of fund) and would not breach the prohibition on the acquisition of an asset by a superannuation fund from a related party, contained in s 66 SISA.

When is an interest in a trust an in-house asset?

Section 71 SISA provides that an in-house asset of a superannuation fund includes an investment in a related trust. Under s 10(1) SISA a trust, other than an excluded instalment trust, will be a related trust of a superannuation fund if a member or a standard employer sponsor of the superannuation fund controls the trust within the meaning of s 70E SISA.

Specifically, s 70E(2) SISA provides that an entity controls a trust if:

- a group in relation to the entity has a fixed entitlement to more than 50% of the capital or income of the trust (entitlement control test);
- the trustee of the trust, or a majority of the trustees of the trust, is accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of a group in relation to the entity (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts) (direction control test); or
- a group in relation to the entity is able to remove or appoint the trustee, or a majority of the trustees, of the trust (removal control test).

Section 70E(3) SISA defines a group for the purposes of s 70E(2) SISA as including an entity and/or the entity's Pt 8 associates.

Accordingly, where an entity being a member or standard employer sponsor of a superannuation fund and/or the entity's Pt 8 associates control a trust under the entitlement control test, the direction control test or the removal control test, the trust will be a related trust for the purposes of the in-house asset rules.

To determine whether a group which includes a member or a standard employer sponsor will be taken to control a trust under either the entitlement control test (through the entitlement to income and capital of its beneficiaries) or the removal control test (through the power to remove the trustee) will involve a careful examination of the trust deed of the relevant trust. Even if a group does not "control" a trust under the entitlement control test or the removal control test, it may be taken to do so under the direction control test. The direction control test is not just concerned with the legal control or the legal rights to the income or capital of a trust, but whether a group has effective control of a trust through the trustee of the trust being accustomed to acting in accordance with the directions, instructions or wishes of the group.

As a general rule, if the trustee of a superannuation fund, the members of that superannuation fund and the relatives and associated companies, partnerships and trusts of those members hold 50% or less of the rights to income and capital, do not control the board of the trustee, and hold 50% or less of the power to remove the trustee (eg through voting rights), the trust will not be a related trust of the superannuation fund for the purposes of the in-house asset rules.

Investment in an unrelated trust being treated as an investment in a related trust

Section 71(2) SISA is an anti-avoidance provision to ensure the related party and related trust provisions are not circumvented through interposed entities.

Under s 71(2) SISA, an investment by a superannuation fund in an unrelated trust will be taken to be an investment in a related trust if the investment was made by the superannuation fund in the unrelated trust as a result of entering into or carrying out an agreement and any of the persons who entered into or carried out the agreement were aware that as a result of carrying out the agreement, an investment would be made in a related trust of the superannuation fund.

Accordingly, where an investment is made by a superannuation fund in an unrelated trust, this will be treated as an investment in a related trust and an in-house asset if any person who entered into or carried out the agreement was aware that the carrying out of the agreement would result in an investment by the unrelated trust in a related trust of the superannuation fund.

Exceptions to the in-house asset provisions

If the trust is an excluded instalment trust as defined in s 10(1) SISA, the trust will not be a related trust. These types of trusts are used for holding derivative products, as the only property of excluded instalment trusts can be listed securities held on trust until the purchase price is paid.

There are also certain investments in related trusts that are exceptions to the in-house asset rules, including:

- an investment in a widely held trust (s 71(1)(h) and 71(1A) SISA);
- subject to ss 71A to 71F SISA, an investment or reinvestment in a pre-12 August 1999 unit trust (although there are a number of additional considerations which will not be identified — see ¶7-155 which looks at pre-August 1999 unit trusts in more detail);
- an investment prior to 12 August 1999 in a unit trust that complies with reg 13.22B SISR or from 12 August 1999 in a unit trust that complies with reg 13.22C SISR (s 71(1)((j) SISA and regs 13.22A to 13.22D SISR); and
- an investment in a trust which holds an asset pursuant to a "limited recourse borrowing arrangement" (s 71(8) SISA).

When will a unit trust comply with reg 13.22C SISR?

In order for an investment in a unit trust not to be an in-house asset under reg 13.22C SISR, the superannuation fund and unit trust must meet the strict criteria of reg 13.22C including:

- the superannuation fund has less than five members;
- the trustee of the unit trust is not a party of a lease with a related party of the superannuation fund unless it is legally binding and relates to business real property;
- the trustee of the unit trust does not have any outstanding borrowings;
- the assets of the unit trust do not include an interest in another entity;
- the assets of the unit trust do not include a loan to another entity;
- the assets of the unit trust do not include an asset over which there is a charge;
- the assets of the unit trust do not include an asset that was acquired from a related party after 11 August 1999 (unless it is business real property acquired at market value); and

- the assets of the unit trust do not include an asset that has been an asset of a related party of the superannuation fund at any time during the three years prior to the superannuation fund acquiring its interest in the unit trust (unless it is business real property acquired at market value).

If the criteria of reg 13.22C SISR are met, then even where a unit trust is a related trust of a superannuation fund, an investment in that unit trust by that superannuation fund will not be an in-house asset. However the trustee of a superannuation fund should be mindful that the investment in the unit trust will subsequently become an in-house asset if the provisions of reg 13.22D are breached (the requirements of which basically mirror reg 13.22C and, in addition, include that the unit trust must not carry on a business).

Investment in a trust — limited recourse borrowing by the trustee of a fund

Briefly, s 67A SISA permits the trustee of a superannuation fund to borrow where the asset acquired with the borrowed funds is "held on trust so that the … trustee of the superannuation fund acquires a beneficial interest in the … asset". The nature of this trust is likely to be a fixed or bare trust.

Investment in a non-related trust that is geared or that has assets subject to a charge

The prohibitions against borrowing (s 67 SISA) prohibit a superannuation fund from borrowing or maintaining an existing borrowing. The prohibition does not apply to a trust that is not a related trust of the fund. Therefore, a fund could invest in a non-related trust that is geared.

Likewise, s 31(1) SISA and reg 13.14 SISR prohibit the trustee of a superannuation fund from giving a charge over an asset of the superannuation fund, but do not prohibit the superannuation fund from investing in a trust where the trustee of that trust has given a charge over its assets.

Unit trusts and the look-through approach

Based on the principle of the separation of legal entities, it would not be expected that the actions of the trustee of a unit trust would be imputed on its unitholders. However, a number of cases over the years have considered the interactions between superannuation funds and unit trusts.[10]

The more recent *Montgomery Wools* case[11] adopted a "look-through approach" where the actions of a pre-12 August 1999 unit trust were imputed to the unitholding superannuation fund as there was a common director in the superannuation fund trustee, the unit trust trustee and the business operating party. In that case, the trustee of the unit trust agreed to allow the commercial property to be used as security for the related party's business operations. The Administrative Appeals Tribunal found that the trustee of the superannuation fund breached the sole purpose test by acquiescing to the charge being granted over the unit trust's asset and by not terminating the unit trust to protect its interests.

---

10 For a more detailed discussion of these cases, see http://sladen.com.au/news/2014/9/15/unit-trusts-and-superannuation-does-the-look-through-approach-exist.

11 *Montgomery Wools Pty Ltd as trustee for Montgomery Wools Pty Ltd Superannuation Fund and FCT* [2012] AATA 61.

Non-arm's length income provisions

Section 295-550 ITAA97 contains the meaning of non-arm's length income. The non-arm's length income provisions were inserted into ITAA97 in the simpler superannuation rewrite replacing the concept of special income contained in s 273 ITAA36. Any non-arm's length income received by a fund will be taxed at the highest marginal rate of 45% (rather than the concessional rates of 15% or 0%). For the 2014-15 to 2016-17 years, the non-arm's length income rate has been increased to 47% (including the 2% Budget repair levy).

Under s 295-550(4) ITAA97, income of a superannuation fund derived from a trust as a beneficiary of a trust, other than because of holding a fixed entitlement to the income, is non-arm's length income of the superannuation fund. A fixed entitlement to income is not defined for the purposes of s 295-550 ITAA97 but is defined for the purposes of Sch 2F ITAA36 to be "a vested and indefeasible interest in a share of the income of the trust". This is a strict definition and would appear to mean that the holding of units in most common unit trusts will not result in the unitholders holding a fixed entitlement.

TR 2006/7, ID 2006/279 and TA 2003/1 each express the view that the meaning of fixed entitlement for the purposes of non-arm's length income or special income will always depend on the rights and entitlements under the relevant trust deed. Income from an interest in a unit trust, a bare trust, a fixed trust and even a non-fixed trust (provided the superannuation fund is entitled to a fixed entitlement to the income) will generally not be non-arm's length income. An entitlement to a distribution from a trust should not depend on the exercise of the discretion of the trustee or any other person.

The Commissioner has indicated in TR 2006/7 that a superannuation fund must have "... an interest in the income of the trust that was, at the very least, vested in interest, if not in possession, immediately before the amount was derived by the trustee". It is stated by the Commissioner that "[a]n interest in the income of a trust estate will be vested in interest if it is bound to take effect in possession at some time and is not contingent on any event occurring that may or may not take place".

Therefore a discretionary distribution of income from a discretionary trust will be non-arm's length income as a fixed entitlement requires a beneficiary to have an interest "... that is susceptible to measurement; a right merely to be considered as a potential recipient of income is not sufficient".

Even if the superannuation fund holds a fixed entitlement to income in a trust, s 295-550(5) ITAA97 provides that income from that trust can still be non-arm's length income if:

- the superannuation fund acquired the entitlement under a scheme, or the income was derived under a scheme, the parties to which were not dealing with each other at arm's length; and
- the amount of the income is more than the amount that the superannuation fund might have been expected to derive if those parties had been dealing with each other at arm's length.

It is therefore important to ensure that, where an investment by a superannuation fund in a trust that provides a fixed entitlement to income and that fixed entitlement is more than might be expected if the parties had been dealing at arm's length, the superannuation fund acquires the interest under an agreement the parties to which were dealing with each other at arm's length.

Does non-arm's length income include statutory income?

Non-arm's length income derived from a scheme in accordance with s 295-550(1) ITAA97 and from dividends paid by private companies under s 295-550(2) ITAA97 applies to both ordinary income and statutory income derived by the superannuation fund and thus removes the previous uncertainty under s 273 ITAA36 as to whether statutory income was special income. This uncertainty remains, however, for trust distributions as s 295-550(4) and (5) ITAA97 refer to "income" derived from a trust. Presumably, this was a drafting error and it was intended that both ordinary income and statutory income derived by the superannuation fund from a trust would fall within the meaning of income under those two subsections. This is the position that the Commissioner took in TR 2006/7 under the previous special income provisions.

Does non-arm's length income include statutory income?

Non-arm's length income derived from a scheme in accordance with s 295-550(1) ITAA97 and from dividends paid by private companies under s 295-550(2) ITAA97 applies to both ordinary income and statutory income derived by the superannuation fund and thus removes the previous uncertainty under s 273 ITAA36 as to whether statutory income was special income. This uncertainty remains, however, for trust distributions as s 295-550(4) and (5) ITAA97 refer to "income" derived from a trust. Presumably, this was a drafting error and it was intended that both ordinary income and statutory income derived by the superannuation fund from a trust would fall within the meaning of income under those two subsections. This is the position that the Commissioner took in TR 2006/7 under the previous special income provisions.

Non-arm's length income and limited recourse borrowing arrangement loans from a related lender

In ID 2014/39 and ID 2014/40, the Commissioner has set out his view of when the non-arm's length income provisions are triggered to capture certain related-party limited recourse borrowing arrangement loans by related lenders.

The two interpretative decisions concern similar factual scenarios surrounding the trustee of a superannuation fund borrowing money from a related party on favourable terms (ie 0% interest rate, high loan-to-value ratios and without personal guarantees from the members). In these scenarios, the Commissioner took the view that the borrowing arrangements were non-commercial and that the income derived from the arrangements is non-arm's length income to the superannuation fund because an arm's length lender would not lend on such terms and therefore the superannuation fund would not be able to acquire the asset (and therefore derive the income).

The Commissioner has indicated that the trustees of superannuation funds are required to enter into borrowing arrangements on commercial terms and, as such, must benchmark any related-party borrowing arrangements against similar financial products available in the market (and keep a record of such benchmark evidence). The Commissioner has not, however, provided any safe harbour guidance and therefore the onus is on superannuation funds to determine what is commercial.

Superannuation funds and public trading trusts

There is a risk that an investment by a superannuation fund in a unit trust may result in the unit trust being taxed as a company and that the flow-through nature of the unit trust will be lost.

The following five tests must be satisfied in order for a trust to be deemed a public trading trust:[12]

(1) Is it a unit trust?

(2) Is it a public unit trust?

(3) Is it a trading trust?

(4) Is the trust a resident unit trust?

(5) The unit trust is not a corporate unit trust.

In broad terms, the key areas of concern for superannuation funds is where the superannuation fund(s) holds or has the right to acquire 20% or more of the units of the unit trust (in which case, the unit trust will be a public unit trust), and whether the unit trust is carrying on a business or controls another entity that is carrying on a business (in which case, it will be a trading trust). If the other four tests outlined above are also satisfied, the unit trust will be taxed like a company, meaning, among other things, that the trust's income is taxed at a company tax rate and the flow-through advantage of the unit trust will be lost.

The government has released the exposure draft of the Tax Laws Amendment (New Tax System for Managed Investment Trusts) Bill 2015, which, if enacted as proposed, would remove the 20% tracing rule for superannuation funds, with the result that the investment of superannuation funds (in itself) will not trigger the public trading trust rules.

¶7-155 Transitional in-house assets post-30 June 2009

A counter argument to the Commissioner's position is that the provisions in s 295-550(1) and (2) ITAA97, which specify that they include statutory income, are intentional and that, absent the specific inclusion of statutory income in the income referred to in s 295-550(4) and (5) ITAA97, income referred to in those latter subsections retains its ordinary meaning.

On 23 December 1999, the in-house asset rules contained in Pt 8 SISA were expanded to include investments in a related party or a related trust of a superannuation fund (fund).

Prior to the amendments, the in-house asset rules under s 71 SISA prohibited investments in "a standard employer sponsor, or an associate of a standard employer sponsor" of a fund. This meant, prior to 12 August 1999, an investment by a fund in a unit trust or a company would generally not be an in-house asset. As the investments in unit trusts and companies were not generally regulated by SISA, such entities (even those controlled by a fund) could invest and conduct their affairs in a manner that potentially circumvented the provisions of SISA. Examples included the purchase by the trustee of a unit trust of a residential property used

12 For a more detailed discussion of the public trading trust rules where their application is caused by a superannuation fund(s) holding units in a unit trust, see http://sladen.com.au/news/2014/8/25/superannuation-funds-and-public-trading-trusts.

by members of the fund which held units in the unit trust and the trustee of a unit trust in which a fund held units borrowing or making loans to related parties of members of the fund.

In accordance with the explanatory memorandum to the legislative amendments the purpose of the amendments was "to ensure superannuation benefits [were] safeguarded in a manner that was originally intended by the [SISA] investment rules".

Transitional arrangements were inserted as Pt 8, Subdiv D SISA (transitional in-house asset rules) to ensure "pre-Budget investments will not need to be unwound" and to "allow the repayment of existing debt of related parties".

What are the transitional in-house asset rules?

The transitional in-house asset rules permit a fund under ss 71A and 71B SISA, without breaching the in-house asset rules, to:

- maintain a loan made before the test time or made under a contract entered into before the test time;
- maintain an investment made before the test time or made under a contract entered into before the test time;
- hold a share acquired before the test time or made under a contract entered into before the test time;
- hold a unit in a unit trust acquired before the test time or made under a contract entered into before the test time;
- hold an asset that is subject to an uninterrupted sequence of leases or lease arrangements with a related party of the fund that began before the test time,

provided that such an arrangement was permitted under the in-house asset rules in existence prior to the test time.

The test time is the end of 11 August 1999 (s 71F SISA). This means that an arrangement entered into on 11 August 1999 (ie before the end of 11 August 1999) will be covered by the transitional in-house asset rules. This is so even though the headings in ss 71A and 71B SISA refer to pre-11 August 1999 investments and leases and presumably it is for this reason that the transitional in-house arrangements are commonly known as pre-11 August 1999 arrangements. In this chapter, the transitional in-house arrangements will be referred to as pre-12 August 1999 arrangements.

The following will focus on the transitional in-house asset rules as they relate to investments in unit trusts as this is the most common form of transitional in-house asset.

Pre-12 August 1999 investments in a pre-12 August 1999 unit trust

Under s 71A(1)(a)(ii) SISA, a unit in a unit trust (pre-unit trust) acquired before the test time or made under a contract entered into before the test time, will not be an in-house asset of a fund, provided the unit would not have been an in-house asset of the fund pre-12 August 1999.

This will be the case regardless of the conduct of or investments made by the pre-unit trust. For example, the pre-unit trust could maintain or increase its borrowings and have dealings with a related party of the fund, without the units becoming an in-house asset.

Even though the investment in a pre-unit trust may not be an in-house asset, that investment may breach other SISA requirements such as the sole purpose test and the requirement to maintain investments on an arm's length basis.

Investments in a pre-unit trust prior to 1 July 2009

If the requirements of either ss 71D or 71E SISA were satisfied, the fund may have acquired further units in a pre-unit trust prior to 1 July 2009 and those units will not constitute an in-house asset.

Investments in a pre-unit trust under s 71E SISA

Under s 71E, if a pre-unit trust had outstanding borrowings immediately before the test time and the fund made a written election by 12 August 2000, the fund may have acquired further units in the pre-unit trust up to the level of the amount of the borrowing outstanding immediately before the test time.

If a fund had made an election under s 71E, the fund could not utilise any of the other transitional in-house asset rules under ss 71A to 71D SISA for investments in a pre-unit trust during the period 12 August 1999 to 30 June 2009.

Section 71D SISA reinvestments in a pre-unit trust

If a fund had not made an election under s 71E, then, under s 71D SISA, the fund may, during the period 12 August 1999 to 30 June 2009, have reinvested the share of the income of a pre-unit trust to which the fund was entitled in further units in the pre-unit trust. Any reinvestment in further units by a fund under s 71D will not constitute an in-house asset of the fund.

Further units may have been acquired under s 71D at any time during the period 12 August 1999 to 30 June 2009. For example, if during the period 12 August 1999 to 30 June 2009 distributions totalling $10,000 had been made to a fund, the fund could invest an amount of $10,000 in the subscription for further units with a value of $10,000 without those units constituting in-house assets of the fund.

Further, prior to 1 July 2009, a fund could have reinvested distributions received from a pre-unit trust in respect of units acquired from earlier reinvestments made during the period 12 August 1999 to 30 June 2009, that is, "income on income".

Assistance when determining the time when a reinvestment was made can be found in SMSFD 2007/1 in which the Commissioner states that a fund will be taken to receive units under a distribution reinvestment as soon as the distribution has been "applied with or dealt with as requested … for example … when the amount is appropriated for the purchase of additional … units … [or] as soon as the set-off happens".

In the determination, the Commissioner takes both a practical yet restrictive approach. The ability to set off the fund's right to be paid a distribution from the pre-unit trust with the fund's obligation to pay the issue price of the "reinvested" units to the pre-unit trust will have provided alleviation from the need to perform the two transactions in cash. However, the requirement that the distribution must have been received by 30 June 2009 will have caused a significant administrative burden for pre-unit trusts as it will require them to calculate or estimate the pre-unit trust's net income on the day of 30 June 2009 and on the same day make the determinations to distribute the net income to the fund, to issue new units to the fund and to set-off the obligation to pay the distribution with the right to receive the issue price.

What happens to pre-unit trusts as from 1 July 2009?

From 1 July 2009, a fund's pre-12 August 1999 units and any units acquired under s 71D or 71E in a pre-unit trust will continue to not be in-house assets of the fund. However, there will be a number of consequences for a fund's investment in a pre-unit trust from 1 July 2009, including those identified below.

Further investments may be in-house assets

Unless one of the in-house asset exemptions applies, from 1 July 2009 any further investments in a pre-unit trust will be an in-house asset. If the aggregate of the market value of that in-house asset and the market value of the fund's other in-house assets exceeds 5% of the market value of the fund's total assets, the fund will be in breach of the in-house assets rules and potentially subject to penalties and tax. Those penalties include the fund being subject to civil or criminal penalties under s 84 SISA, the fund potentially losing its complying status with a result that the market value of the Fund's assets less non-concessional undeducted contributions is subject to tax at 46.5% under s 295-325 ITAA97.

In addition, any further acquisition of units may breach the prohibition against a fund acquiring assets from a related party.

Distributions from a pre-unit trust must be paid

From 1 July 2009, what will be the consequences of an amount of income to which a fund is entitled from a pre-unit trust remaining unpaid in part or in full? Will this constitute an investment by the fund in a related trust or breach another provision of SISA?

In SMSFR 2009/3, the Commissioner stipulates that where a fund is presently entitled to a distribution from a related trust, that unpaid distribution will potentially be an in-house asset, breach the arm's length rules and cause the fund to be in breach of the sole purpose test. The Commissioner also states that adding a "distribution" to the corpus of the trust may also be an investment in a related trust under the in-house asset rules.

Therefore, unless the fund wishes to challenge the Commissioner's ruling, the prudent course of action would be to ensure that all distributions from a related pre-unit trust are paid in cash soon after the relevant appointment/distribution of income is made.

Problems with repayment of loans by a pre-unit trust from 1 July 2009

From 1 July 2009, if a pre-unit trust has an outstanding loan, the Commissioner's requirement that all distributions must be paid in cash could potentially cause the pre-unit trust to make a decision that will either cause it to be in breach of its loan agreement or cause the fund to be in breach of the SISA provisions.

If a pre-unit trust's loan agreement requires the pre-unit trust to pay principal and interest, and the pre-unit trust has no other cash, necessarily it will apply some of its income towards the payment of interest and principal if it is to avoid defaulting under the loan agreement. This is potentially in conflict with the Commissioner's view that all of a pre-unit trust's net income must be paid to the unitholders. Before 1 July 2009, this problem could have been overcome by a pre-unit trust paying all of its distributions to a fund which in turn could reinvest those distributions for the subscription of further units, but from 1 July 2009 this option is not available.

For example if, from 1 July 2009, a pre-unit trust (with a fund as its sole unitholder) earns $100 of gross income and has an obligation to pay $20 of interest and repay $30 of principal, the pre-unit trust will have net income of $80 (that is, gross income of $100 less deductible interest of $20) and an obligation to pay $30 to the lender as a repayment of principal. If that pre-unit trust has no other cash sources it will have two options. First, it could pay the $30 to the lender in which case it could only pay $50 of the $80 of income appointed to the fund and the remaining unpaid appointment of income of $30 will potentially be in breach of the in-house asset rules or the sole purpose test. Second, it could pay the $80 of income appointed to the fund and be in breach of its loan agreement with the lender.

To avoid these difficulties, it would seem to be necessary for:

- either the fund to dispose of its units in the pre-unit trust; or
- the trustee of the pre-unit trust either to sell the asset to which the relevant loan attaches or vest the pre-unit trust; and/or
- for the pre-unit trust to accumulate some or all of its income.

As discussed below, potential capital gains tax, income tax, stamp duty and SISA consequences should be reviewed before determining the action to be taken.

Unpaid purchase price on units held in pre-unit trusts may become in-house assets

Under s 71A(2) SISA, if at 12 August 1999 a fund held units in a pre-unit trust where part of the purchase/issue price was unpaid, the payment of all or part of that purchase price before 1 July 2009 would not have constituted an in-house asset.

However, from 1 July 2009, an amount paid towards the purchase price of units held by a fund will cause those units to be an in-house asset. The in-house asset value of those units will equal the market value of the units multiplied by the proportion that the post-30 June 2009 payments make up of all of the payments made towards to the purchase price of the units in accordance with the formula in s 71A(3).

What action should a pre-unit trust take from 1 July 2009?

What action, if any, a pre-unit trust or a fund that holds units in a pre-unit trust should take before and from 1 July 2009 will depend on individual circumstances. That action could include those identified below.

Pay all entitlements to income

From 1 July 2009, a pre-unit trust should pay all entitlements to income.

Before 12 August 1999, units held by a fund, and all units acquired under s 71D or 71E will continue not to be in-house assets post-30 June 2009 and all distributions of income which are paid in full will not give rise to in-house assets.

As units in a pre-unit trust will not constitute in-house assets of a fund, there will continue to be no direct restrictions under SISA on the transactions and investments of the pre-unit trust. For example, a pre-unit trust can maintain a borrowing, enter into a new borrowing arrangement and transact with related parties of the fund. However, as discussed above, the actions of the pre-unit trust may cause the investment by the fund in that trust to breach a provision of SISA, such as the sole purpose test, the requirement to maintain investments on an arm's length basis and the prohibition against the acquisition of assets from a related party.

Accumulation of income from a pre-unit trust

If as a result of cash flow difficulties a pre-unit trust is not able to distribute all of its income, the pre-unit trust could determine to accumulate some or all of the income (subject to the deed of the pre-unit trust providing it with that power). Any income accumulated will be subject to tax at the rate of 46.5% (s 99A ITAA36) but that may deliver a better result than the sale of assets or the vesting of the pre-unit trust.

Maximise reinvestments under s 71D SISA before 1 July 2009

If a fund had not reinvested all of its distributions made during the period 12 August 1999 to 30 June 2009, the fund had until 30 June 2009 to do so. This included any distributions made during that period even if they had been previously paid.

As noted above, the Commissioner's view is that any reinvestments for the 2008-09 year must have been made by 30 June 2009 and therefore it was important that pre-unit trusts determine their net income and make any reinvestments on that date.

In addition, the pre-unit trust could have considered realising assets before 1 July 2009. If the realisation had resulted in an increase of the net income of the pre-unit trust and as a result the distribution available for reinvestment, this could have resulted in the pre-unit trust holding additional cash for use in the retirement of debt, allowing for further investments or payment of future distributions. Before an asset is sold by a pre-unit trust or any other entity, the capital gains tax consequences should be considered.

Converting a pre-unit trust to a reg 13.22C SISR trust

With no further exemption from the in-house asset rules available after 30 June 2009 for any additional investments in pre-unit trusts, parties often wish to convert to a trust that meets the requirements of reg 13.22C SISR.

If this is possible, it would mean that a fund could make further investments in the trust, even after 30 June 2009, without these being in-house assets and without any restriction on the value of the investments made. However, the Commissioner's stated view is that further investments may only be made by a fund in a pre-unit trust after 30 June 2009 (without these being in-house assets of the fund) if the trust has discharged any pre-28 June 2000 borrowings before the new units are issued and provided the trust has continued to meet all of the requirements since 28 June 2000. This means that the trust must not have undertaken any new borrowing after 28 June, even if that borrowing has subsequently been discharged.

In practice, this will rule out opportunities to convert for some pre-unit trusts. Those that wish to convert will need to carefully examine the history of the pre-unit trust's activities.

Sale of units in or vesting of a pre-unit trust

If is not possible to pay distributions in cash or to ensure the pre-unit trust meets the requirements of reg 13.22B SISR, the fund could consider selling its units or the pre-unit trust could consider redeeming the fund's units or vesting the pre-unit trust.

To reiterate, before any of these actions are undertaken the potential capital gains tax, income tax and stamp duty consequences must be considered. Further, if the relevant pre-unit trust is vested and its assets transferred to a fund, care should be taken to ensure this does not result in the fund acquiring an asset from a related party in breach of s 66 SISA. This could occur, for example, if residential property was transferred from the pre-unit trust to the fund.

Distribute the fund's units to a member as a benefit

If a member has met a condition of release (other than as a result of receiving a transition to retirement income stream), the fund could consider transferring the units in the pre-unit trust in specie to the member by way of a lump sum benefit. An asset cannot be cashed or transferred in specie as a pension benefit — see para 10 of APRA's Superannuation Circular N.I.C.2 Payment Standards for Regulated Superannuation Funds.

The distribution of the fund's units to a member will remove a potential in-house asset from the fund. However, before the units are transferred, the advantages of the retention of the units by the fund should be considered along with the potential capital gains tax, income tax and stamp duty consequences to the fund and the member.

Glossary

Accounting income	Any money received by a trust which is properly recorded as an income receipt as opposed to a capital receipt in the books of account of the trust.
Active investments	Investments that expose their holder to possible further liability (an interest in a partnership is an example of an active investment because the partner can be liable for future debts incurred by other partners beyond the original amount he has contributed to the partnership).
Appointment of income and/or capital	A determination by the trustee of a trust in accordance with the terms of the trust deed to declare an entitlement to income or capital in favour of a beneficiary of the trust but should be distinguished from a distribution.
Appointor	A person or persons who can, in defined circumstances, appoint or remove the trustee of a trust. The appointor can exercise strong powers and, in effect, can "control" the trust because they can appoint the trustee who then operates the trust. An appointor is usually the primary beneficiary (or one of the primary beneficiaries) of the trust and an independent adviser and/or a trusted friend of the primary beneficiary(ies).
ATO	The Australian Taxation Office.
Beneficiary	A person who may benefit under a trust. Sometimes, a beneficiary can direct the trustee to deal with the trust property in a certain way. A beneficiary of a discretionary trust usually has no fixed interest in the property held by the trustee and is merely a discretionary object of the trust. Nevertheless, that beneficiary may have certain rights to recover the trust property from a third party who has no right to the property. All beneficiaries of legal capacity have the right to make the trustee carry out the terms of the trust.
Capital gain	In very general terms, this refers to the capital amounts a person receives, is entitled to receive, or would receive if the transaction was conducted with arm's length parties, from a CGT event in excess of the person's total costs associated with that CGT event (including the cost of the asset associated with the CGT event).
Capital gains tax	The tax payable on a capital gain (there is no separate capital gains tax but rather the amount of any capital gains is included in the taxpayer's assessable income and subject to income tax in the hands of the taxpayer).
CGT concession stakeholder	A person who is a significant individual.
CGT concessions	The discount capital gains and the small business CGT concessions.
CGT event	An event (such as a sale of real property) for which a taxpayer can make a capital gain or loss under the tax law.

CGT	Capital gains tax.
Charitable institution	A establishment, organisation or association that has the requisite purpose necessary for it to be considered charitable.
Charitable trust	A trust that has the requisite purpose necessary for it to be considered charitable.
Closely held trust	A trust is closely held if an individual has, or up to twenty individuals have, between them; or no individual has, or no individuals have between them directly or indirectly and for their own benefit fixed entitlements to a 75% or greater share of the income or capital of the trust.
Commissioner	The Commissioner of Taxation.
Constitution	A legal document which is the governing document of a company.
Discount capital gain	A capital gain that satisfies the requirements in Div 115 ITAA97 and is then reduced by 50% (in respect of an individual or trust) or 33⅓% (in respect of a superannuation fund).
Distribution of income and/or capital	The actual distribution (or payment) of income or capital to the beneficiary to whom it was appointed in favour of.
50% CGT discount amount	The non-assessable part of a capital gain made by a trust or individual where the capital gain is a discount capital gain.
Family trust election	An election made pursuant to sch 2F ITAA36 which defines a family group based on an identified individual (the test individual) who alone or with others has some control in relation to operation of the trust.
Fixed trust	A trust is a fixed trust if persons have a fixed entitlement to all of the income and capital of the trust.
Franked dividend	Franked dividends are payments made to shareholders on which the company has already paid tax. These payments carry franking credits.
Franking credits	A franking credit is the organisation's share of tax paid by a company on the profits from which the organisation's dividends or distributions are paid.
GST	Goods and services tax.
In-house assets	A loan, an investment in or a lease or lease arrangement made by the trustee of a superannuation fund with or in a related party or trust that may result in a breach of the in-house asset rules under the SISA.
In-house asset rules	The rules contained in the SISA that limit the amount of in-house assets the trustee of a superannuation fund may hold.

In specie distribution	The distribution of an asset in its current form to a beneficiary of the trust.
Inter vivos trust	A trust established during a person's lifetime.
Interposed entity election	An election made by a second entity to be included within the family group of the test individual (nominated pursuant to a family trust election).
ITAA	The *Income Tax Assessment Act 1936* and/or the *Income Tax Assessment Act 1997*.
ITAA36	The *Income Tax Assessment Act 1936*.
ITAA97	The *Income Tax Assessment Act 1997*.
Mere objects	The beneficiaries of a discretionary class of beneficiaries of a trust who have no rights in the assets of the trust other than the right to the due administration of the trust.
Passive investments	Investments that do not expose their holder to any further financial liability (fully paid shares in a proprietary limited company are an example of a passive investment because the shareholder cannot be held liable for any debt of the company merely as a result of the shareholder holding shares).
SDT	Special disability trust.
Settlor	A person who "settles" a trust. The trust is "settled" by the settlor making an initial contribution to a trustee (usually this is a nominal sum, for example, $20) to hold and deal with on behalf of beneficiaries in accordance with the trustee's obligations under the trust deed. That initial contribution forms the original trust fund. Settlors then have no interest in the management of the trust and can neither benefit from it nor be held liable for any misfeasance of the trustee.
Significant individual	A person with a small business participation percentage of at least 20%.
SISA	The *Superannuation Industry (Supervision) Act 1993*.
Small business CGT concessions	A number of concessions that, in certain circumstances, apply to reduce, remove or defer the liability of a taxpayer to pay capital gains tax. They are set out in Subdiv 152 ITAA97 and includes the 50% active asset reduction, the 15-year exemption, the retirement exemption and the roll-over.
Small business participation percentage	In summary, the extent to which the individual participates, directly and indirectly, in the income or capital of a trust or voting power, dividends or distributions of capital from a company.

Testamentary trust	A trust established under a will when the testator dies. It is this establishment on death that distinguishes a testamentary trust from an inter vivos trust. In other respects, a testamentary trust has much in common with an inter vivos trust.
Trust deed	A legal document in the form of a deed that establishes a trust.
Trust	A relationship between a person, persons or entity (called the trustee) and another person, persons or entity (each a beneficiary) in which the trustee holds property in its own name (the legal interest) for the benefit of the beneficiary or the beneficiaries, or for some object or purpose permitted by law.
Trustee	An individual or a company that holds property in its own name on trust for another person.
Unfranked dividend	Unfranked dividends are dividends paid to shareholders by a company that has not already paid australian company tax.
Vesting	Refers to the vesting of all of the assets of the trust in the relevant beneficiaries and the winding-up of that trust in accordance with the terms of the trust deed.
Widely held unit trust	A trust is a widely held unit trust if it is a fixed trust that is a unit trust, and it is not closely held.

Index

D

U

V

W

Cases

A

Legislation

Rulings, determinations etc