# The Tax Summit

## Session 4.3: Demystifying family discretionary trusts – what a modern-day practitioner should know

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# 1. Overview

Trusts are a centuries-old tool that has become one of Australia's most popular investment and business vehicles. Data from the Australian Taxation Office (**ATO**) shows that between 2019 to 2021, the number of trusts in Australia grew from 907,914 to 947,264 (on average, an increase of roughly 20,000 trust vehicles per year).[1]

There are a range of trust vehicles in Australia, such as unit trusts, fixed trusts, hybrid trusts, testamentary trusts, special disability trusts, charitable trusts, superannuation funds, bare trusts and statutory trusts. Family discretionary trusts, in particular, are commonly used to hold personal and family wealth.

Though the benefits of trusts in terms of asset protection, taxation and success planning are commonly understood, their nature is often misconstrued. This is illustrated in the recent decision of *Owies v JJE Nominees Pty Ltd*[2], which affirms long-standing trust law principles that a trustee does not necessarily have the absolute discretion to deal with assets as it wishes and has fiduciary duties towards the trust and its beneficiaries.

In the last few years, the ATO has also taken active steps to warn taxpayers about the consequences of blatantly using trusts for tax manipulation. This includes issuing guidance on section 100A of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**) in Taxpayer Alert TA 2022/1, Taxation Ruling TR 2022/4 and Practical Compliance Guideline PCG 2022/2 and on the application of Part IVA of ITAA 1936 in relation to personal services businesses in Practical Compliance Guideline PCG 2024/D2 (currently open for consultation until 11 October 2024).[3] There is, on one view, a heightened tax risk environment in relation to the use of trusts.

In this paper, we consider the family discretionary trust and examine core principles that, in the author's view, a modern-day practitioner should be aware of. We will examine the following:

- *Section 2:* An introduction to family discretionary trusts
- *Section 3:* Importance of the trust deed
- *Section 4:* The trustee's fiduciary duty
- *Section 5:* Why a family discretionary trust?
- *Section 6:* Why not family discretionary trust?
- *Section 7:* Designing the family discretionary trust
- *Section 8:* Distributing annual trust income
- *Section 9:* Amendments to the trust deed
- *Section 10:* Resettlement of the trust

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[1] https://www.ato.gov.au/about-ato/research-and-statistics/in-detail/taxation-statistics/taxation-statistics-previous-editions/taxation-statistics-2020-21/statistics/trust-statistics

[2] [2022] VSCA142

[3] These publications are in addition to the recent draft guidance issued by the ATO on 31 July 2024 on section 99B of ITAA 1936 in Taxation Determination TD 2024/D2 and Practical Compliance Guideline PCG 2024/D1. This paper will not examine section 99B, as it does not concern Australian trusts but relates to foreign trusts. However, the observation on section 99B is that it is prudent for practitioners to be cognisant of the provision because—as the ATO observes—with increasing globalisation and migration flows into and out of Australia, it is becoming increasingly common for resident taxpayers to receive benefits from non-resident trusts (including deceased estates). It is prudent to consider the potential application of section 99B for an Australian resident taxpayer receiving a distribution or gift from offshore because if section 99B applies, it can result in a substantial part of the distribution being subject to Australian income tax.

- *Section 11:* Vesting of the trust.

# 2. An introduction to family discretionary trusts

## 2.1 What is a trust?

At the outset, it is important to appreciate that a trust is not a legal entity.[4] It is better described as an equitable obligation (or a relationship) binding a person (who is called a trustee) to deal with property over which it has control (which is called trust property) either for the benefit of persons (who are called the beneficiaries) of whom it may be one, and any one of whom may enforce that obligation.

As French J stated in *Harmer and Ors v Federal Commissioner of Taxation*[5] in relation to a trust: "*It is notably a definition of a relationship by reference to obligations*."

The Australian courts have over time identified a set of indicia that suggests when a trust relationship exists. In the High Court of Australia's decision in *Korda v Australian Executor Trustees (SA) Limited*[6], French CJ cited the following from the American Law Institute's Restatement Third, Trusts in describing an 'express trust':

> *"[It is] a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee."* [7]

In determining whether a relationship is sufficient to constitute as an 'express trust', it is necessary to inquire whether the relationship exhibits certain characteristics. *Jacobs' Law of* Trusts *in Australia*[8], which has been cited by Australian courts in a number of cases, suggests that the following four elements—depending on context—may be treated as indicia on the existence of a trust relationship:

- there must be property capable of being held on trust;
- there must be a trustee in existence who has an obligation to deal with the trust property in accordance with the terms of the trust;
- there must be beneficiaries or an identifiable class of beneficiaries, other than the trustee; and
- the terms of the trust must be certain, such that there is a personal obligation on the trustee to deal with trust property for the benefit of the beneficiaries.[9]

In addition to the above four elements, the courts have identified 'three certainties' that should exist to establish a valid trust relationship. In *Knight v Knight*[10], Lord Langdale stipulated that no trust will be valid unless there are certainty of words (or intention), certainty of subject matter and certainty of object. At a high level, this broadly requires the following:

[4] There are, however, instances where legislation may at times "deem" a trust to be a legal entity for the purpose of that legislation, therefore creating a "fiction. For example, a trust is treated as a legal entity for tax administration purposes.

[5] (1989) 20 ATR 1461.

[6] [2015] HCA 6.

[7] See [5] of *Korda*.

[8] 8th ed. LexisNexis Butterworths, 2016.

[9] J D Heydon and M J Leeming, *Jacobs' Law of Trusts in Australia* (8th ed. LexisNexis Butterworths, 2016) at [1-04] to [1-10].

[10] (1840) 3 Beav 148.

- there is certainty of an intention that the trust property was to be held on trust (i.e. an intention to create a trust by the settlor)—the settlor must have intended to create a trust of property, as opposed to making a gift or lending;
- there is certainty of trust property (subject matter); and
- there is certainty on the beneficiaries (objects).

When it is appreciated that the trust is built around relationships and obligations, it does not become surprising that care is required of the trustee in administering the trust, including in considering the potential interests of beneficiaries. In particular, the trustee is not necessarily free to act as it wishes without regard to the intentions of the settlor and its duties to the trust and beneficiaries—notwithstanding that the trustee may be controlled by the appointor and the principal(s) of the family.

It is also important to appreciate what gives rise to a valid trust relationship in Australia because, at times, you may be presented with an arrangement that is assumed by the client and everyone else to be a trust but, upon closer examination, it is questionable whether the arrangement meets the legal requirements of being a trust.

For example, in the decision of *Bendel v Commissioner of Taxation*[11], the Administrative Appeals Tribunal observed that an unpaid present entitlement held on 'sub-trust' does not appear to give rise to a trust relationship—notwithstanding that both the taxpayer and the Commissioner had accepted that a separate trust was either created or arose upon vesting of entitlements to trust income:

> *"[79] In the present circumstances, where it is not possible to identify any asset or property held on any separate trust as conventionally understood, notwithstanding the acceptance of the parties that a separate trust was created, what was created upon passing resolutions to distribute Gleewin's income was a right or entitlement for the beneficiary coupled with the corresponding obligation of the trustee of a nature contemplated by what Gageler J said in Fischer v Nemeske.*
>
> *[80] Accordingly, the Tribunal does not accept contentions that a separate trust in fact arose in any conventional sense that had the effect of discharging or replacing the obligation to pay entitlements to income. Those entitlements to be paid shares of Gleewin's income continued to exist."*

## 2.2 What is a family discretionary trust?

Under trust laws, there is no such thing as a family discretionary trust. Rather, family discretionary trusts generally have the characteristics of an express trust. Thus, a family discretionary trust is a label[12] commonly given to an express trust, where a person (known as the settlor) invites another person (known as the trustee) to hold assets from time to time (known as trust property) for the benefit of a group of people defined by reference to a family (the beneficiaries), and the trustee accepts the invitation from the settlor.

Subject to the trust terms, the trustee generally has autonomy to distribute trust income and assets to one or more of the beneficiaries (of which it may be one) to the exclusion of others. Unlike a fixed trust, where beneficiaries have a positive right to trust income and assets,[13] beneficiaries of a discretionary trust do not

[11] [2023] AATA 3074.

[12] In *FCT v Ramsden* [2005] FCAFC 39 at [32], the Full Court of the Federal Court observed: "*The expression 'discretionary trust' is not a term of art, but merely a useful description. The term serves a useful purpose in emphasising the instability of the interests and prospective interests of those taking under the deed: Chief Commissioner of Stamp Duties for NSW v Buckle [1998] HCA 4; (1998) 192 CLR 226 at 243."*

[13] See *Baker v Archer-Shee* [1927] UKHL 1.

possess a positive right to trust income and assets until such time as the trustee had exercised a discretion to allocate any trust income and/or asset in their favour.[14]

Therefore, subject to the trust terms, a beneficiary's right under a discretionary trust is generally limited to the following:

- a mere expectancy to be considered by the trustee to receive any trust income and assets from time to time; and
- a right to compel the proper administration of the trust estate (for example, to prevent a rogue trustee from attempting to sell the trust property to a third party).[15]

## 2.3 Common anatomy of a family discretionary trust

These days, family discretionary trusts are a relatively common vehicle. However, their terms can vary. The range of family discretionary trusts include those that were settled many decades ago to those that were settled more recently, with different language and drafting styles. For a family discretionary trust that was settled a while ago, there may be multiple amendments to the original trust deed to accommodate for exigencies over time, such as succession planning and tax matters (e.g. inclusion of a 'foreign beneficiary' exclusion clause to prevent the surcharge duty and land tax surcharge from applying).

Generally, the trust deed of a family discretionary trust is comprised of the following key components:

- ***Declaration of the trust:*** The trust is declared with a stated name and an express intent by the settlor to settle trust property upon the trustee for the benefit of the beneficiaries. Often, the trust property is comprised of a nominal amount of settlement sum. The role of the settlor is also often limited to establishing the trust, but this may not be the case.
- ***Trustee of the trust:*** This is the person who legally holds the trust property and is mandated by the settlor to administer the trust in accordance with the trust terms and for the benefit of the beneficiaries. The trustee can be one or more individuals or a company. Its role is fiduciary in nature.
- ***Appointor of the trust (sometimes known as Guardian of the trust):*** This is the person vested with power to appoint and/or remove the trustee. The role is fundamentally supervisory in nature. The appointor is sometimes required to be consulted by the trustee in relation to certain matters (e.g. before exercising a trustee power). Whilst the appointor is generally regarded as the controller of the trust, its role is fiduciary in nature.[16]
- ***Beneficiaries of the trust:*** This is the group of persons who may benefit from the trust. The group of beneficiaries is often defined by reference to one or more named individuals, and includes their immediate family members, lineal descendants and entities associated with them (such as companies and other trusts). The beneficiary class is often drafted widely, but there is a question whether this is

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[14] See, e.g., *Dial A Dump Industries Pty Ltd v Roads and Maritime Services* [2017] Hcasl 236.

[15] See, e.g., *Gartside v Inland Revenue Commissioners* (1968) AC 553. The UK decision of *Gartside* has been adopted in numerous Australian cases, including *Lygon Nominees Pty Ltd v Commissioner of State Revenue* [2005] 60 ATR 135. See also *Hja Holdings Pty Ltd and Ors & Act Revenue Office (Administrative Review)* [2011] ACAT 91.

[16] Note the case of *Baba v Sheehan* [2021] NSWCA 58, where the Supreme Court of NSW stated: *"the effect of replacing Smart Street with Silktote was to remove from Mr Baba and Mr Carney any capacity to have a say in the affairs of the Trust and to limit those who have such a say to Mr Sheehan and his wife. If that were the purpose and intention of Mr Sheehan in exercising the power, it would be for a foreign purpose and be void and ineffective. However, if Mr Sheehan, as Appointor, in good faith formed the view that it was in the interests of all of the Unitholders that Smart Street be replaced with Silktote because Silktote was better qualified to manage the affairs of the Trust and the Trust Business, there would be no fraud on the power."*

appropriate (see section 7 for a discussion on this matter). Further, there may be different classes of beneficiaries—such as those who may only benefit from income of the trust, those who may only benefit from capital of the trust, those who may benefit from both income and capital of the trust and those who are the takers-in-default (i.e. the default beneficiaries in the event that the trustee fails to distribute any trust income or upon the vesting of the trust).

- ***Trustee's powers and responsibilities:*** The trustee is generally given broad powers to administer the trust, including to undertake investments. Such powers include the power to borrow, to lend, to provide security, to occupy property, to keep accounts, to enter into contracts and give undertakings, to appropriate assets, to value assets and to carry on a business. The trustee is also generally empowered to distribute income and/or capital of the trust in its absolute discretion. Notwithstanding broad powers and an absolute discretion provided to the trustee, the trust terms may express limitations on these powers and/or require the trustee to consult the appointor/guardian of the trust before exercising its discretion. The trustee has a fiduciary duty in exercising its powers (see section 4 for a discussion on this matter).

- ***Definitions:*** Defined terms used in the trust deed, which may include terms such as:

  - 'Income of the trust': being accounting income, net income (i.e. income according to the tax legislation);

  - 'Child': whether this includes a legally adopted child;

  - 'Shares and proportions': which suggests that the trustee is able to stream dividends and capital gains to particular beneficiaries to the exclusion of others; and

  - 'Spouse': whether this includes those in a de facto relationship.

- ***Amendments (or variations) of the trust:*** There is no inherent power to vary a trust deed under the general law or the Trustee Acts. Accordingly, this power must expressly derive from the terms of the trust deed. Amendment powers are generally provided to the trustee. They can be broad or narrow, and permissive or stringent when it comes to the requirements surrounding its exercise, including whether any approval is required by the trustee to make an amendment and whether any particular clauses are irrevocable and cannot be amended. Regardless of the nature of the amendment power, there is risk of resettlement of the trust where the scope and method stipulated for amendment are not exactly complied with. See section 9 for a discussion on this matter.

- ***Vesting day (or termination date):*** This is commonly understood as when the trust comes to an end. However, it is more accurate to describe vesting as the date or an event (such as a named beneficiary attaining a certain age) upon which the beneficial interests in the trust property become fixed (i.e. the discretionary nature of the trust ceases). This is to avoid breaching the 'rule against perpetuities'.

  The 'rule against perpetuities' requires that future trust interests must be certain to vest within a defined period of time known as the 'perpetuity period'. This rule is based on a 1681 decision of Lord Nottingham LC in *The Duke of Norfolk's* case.[17] The 'rule against perpetuities' operates to ensure that the vesting of an interest in property is not postponed indefinitely—in other words, that assets cannot be held in trust indefinitely.

  With the exception of South Australia, all states and territories have introduced legislation to limit the 'perpetuity period' to a maximum of 80 years from date of settlement of the trust.

[17] (1681) 3 Ch Cas 1, 22 ER 931.

The vesting of the trust does not always end the trust or create a new trust. Depending on the terms of the trust deed, the trustee may be permitted to hold trust property for specified beneficiaries after the vesting day, such that the same underlying trust relationship continues (although the discretionary powers of the trustee cease). See section 11 for a discussion on vesting.

- ***Applicable law of the trust:*** This is the governing law of the trust, such as the State of New South Wales.

# 3. Importance of the trust deed

There is an age-old mantra that one must always ‘read the deed’ when administering the trust. After all, a trust is created when the settlor invites the trustee to accept its trustee role subject to the terms and conditions of trust powers that exist at common law, in statute (such as a *Trustee Act*) and as may exist or is modified by the trust deed. If the trustee does not ‘read the deed’, then how would it determine the scope and limitations of its role and matters of the trust.

A trustee and its advisers cannot simply assume that all family discretionary trusts are the same and that all trust terms are the same. In administering the trust, the trustee must take care in reading and understanding the trust terms, including the scope of its powers, any procedural matters required to be followed in exercising a discretion and, where the drafting is unambiguous, how such ambiguity may be resolved.

The decision in *Advanced Holdings Pty Limited as trustee for The Demian Trust v Commissioner of Taxation*[18] reinforces the importance of ‘reading the deed’.

***Advanced Holdings Pty Limited atf The Demian Trust v Commissioner of Taxation* [2020] FCA 1479**

***Facts***

Mr Demian, the principal of a discretionary trust known as The Demian Trust, executed a deed that purported to appoint Advanced Holdings as the new trustee. His power to do so ostensibly derived from the following power in the trust deed:

> *“22. The Principal may at any time by notice in writing to the Trustee remove from office any or all of the Trustees or Trustee for the time being of this Deed and may by Deed appoint a new Trustee in its or their place to be the Trustee hereof…”*[19]

***Issues***

An issue before the Court was whether the power to appoint the new trustee had been validly exercised by Mr Demian. Mr Demian had signed a document entitled ‘Deed of Appointment of a Trustee’ addressed to ‘the Trustee and Beneficiaries’ of the Demian Trust. The document stated:

> *“Pursuant to clause 22 of the trust deed dated 20th March 1998 governing the said Trust, I appoint Advanced Holdings Pty Limited as trustee of the Demian Trust.”*[20]

The Commissioner argued that clause 22 of the Demian Trust Deed is a power of the Principal in two parts. First, it is a power of removal of a trustee in office. Secondly, supplementary to the first power, it is a power to appoint a new trustee in substitution of the removed trustee. It was submitted that clause 22 is not a power to appoint an additional trustee or trustees. As at 2 April 2003, Demian Holdings was the trustee of the Demian Trust and no notice in writing removing it was signed by Mr Demian as Principal. As a consequence, it was argued that the power to appoint a replacement trustee in clause 22 of the Demian Trust never arose, with the result that the appointment of Advanced Holdings as trustee on 2 April 2003 was ineffective.

[18] [2020] FCA 1479.

[19] See [88] of *Advanced Holdings*.

[20] See [89] of *Advanced Holdings*.

***Outcome***

The court took a strict interpretative approach to interpreting clause 22, finding that Advanced Holdings had not, in fact, been validly appointed as the trustee:

> *"94. The clause, properly construed, requires one or more trustees to be removed (including by retirement: cl 15) and, that having happened, permits one or more trustees to be appointed in their place. Removal is the pre-condition of the power of appointment. Accordingly, I find that Advanced Holdings was not validly appointed as trustee of the Demian Trust in 2003."*

The Applicant alternatively argued that if the appointment was not effective in 2003, Advanced Holdings was validly appointed as trustee of the Demian Trust in November 2006. Mr Demian's evidence was that by 2006 he had formed the view that Demian Holdings should not continue to act as trustee of the Demian Trust and he decided to retire Demian Holdings as trustee and to appoint Advanced Holdings as the sole trustee of that trust. He deposed that on 13 November 2006 he caused the following to happen:

- Demian Holdings resolved to retire as trustee of the Demian Trust;
- on behalf of the Demian Trust he accepted the resignation of Demian Holdings as a trustee of the Demian Trust and appointed Advanced Holdings to continue as trustee and become sole trustee of the Demian Trust; and
- Advanced Holdings resolved to consent to being appointed as the sole trustee of the Demian Trust.

The Applicant had tendered documents in support of the proper exercise of the power of appointment. However, the court was not persuaded:

> *"97. I do not accept on the strength of these documents that Demian Holdings in fact retired or resigned as represented, or was removed as trustee of the Demian Trust so as to satisfy the condition to enliven the power in cl 22 of the Demian Trust Deed for the Principal to appoint a new trustee.*
>
> *98. First, there was no evidence of a resignation notice executed by Demian Holdings, let alone the resignation notice purportedly tabled at the meeting of the directors of Demian Holdings on 13 November 2006.*
>
> *99. Secondly, and correlatively, there was no evidence that Demian Holdings gave written notice of its intention to resign as trustee of the Demian Trust as required by cl 15(a) of the Demian Trust Deed. Clause 15(a) provides:*
>
>> *Retirement of Trustee*
>>
>> *The Trustee may at any time resign from the office of Trustee by giving not less than two (2) months' notice in writing (which may be withdrawn by the Trustee) addressed to the person or persons in whom the power of appointing a new Trustee or new Trustees of the settlement is then vested.*
>
> *Moreover, it may reasonably be inferred that such notice was not given, as the document headed "Notice of Removal of Trustee" provided that the resignation would be "effective immediately".*
>
> *100. Thirdly, whilst in cross-examination Mr Demian identified the document headed "Notice of Removal of Trustee" as the Deed of Retirement of Trustee referred to in the minutes of meeting of the directors of Demian Holdings, the "Notice of Removal of Trustee" was executed by*

*Mr Demian in his personal capacity and not by him on behalf of the Demian Holdings. It was not "the resignation" by Demian Holdings as trustee.*

*101. Fourthly, although entitled "Notice of Removal of Trustee" the document did not purport to be an exercise of power by Mr Demian as Principal under cl 22 to remove Demian Holdings as trustee. Rather, the notice assumed a prior effective resignation by Demian Holdings as trustee.*

*102. Fifthly, the Deed of Retirement and Appointment of Trustee referred to in the Minutes of Demian Holdings and recorded as tabled at the meeting of the directors of Advance Holdings was not produced in evidence.*

*103. Accordingly I find that Advanced Holdings was not validly appointed trustee of the Demian Trust in 2006."*

# 4. The trustee's fiduciary duty

As noted, a trust is not a legal entity and is better described as an equitable obligation (or a relationship) binding the trustee to deal with trust property for the benefit of the beneficiaries. This equitable obligation imposes on the trustee a presumed fiduciary relationship towards the trust and its beneficiaries.[21]

Whilst there is no universally accepted definition of a fiduciary relationship, it is at its core an obligation of confidence, reliance and trust (or 'undivided loyalty'[22]), the purpose of which is to prevent a possible abuse of power by the trustee.

In *Adventure Golf Systems Australia Pty Ltd v Belgravia Health & Leisure Group Pty Ltd*[23], Santamaria JA described the obligation flowing from a fiduciary relationship as follows:

> *"The essence of a fiduciary relationship is that one party of the relationship is obliged to act in the interests of another party to the exclusion of the former's self-interest. As a result, the fiduciary is prevented from entering into any engagement in which a fiduciary has, or could have, a personal interest conflicting with that of his or her principal; nor is the fiduciary allowed to retain any benefit or gain obtained or received by reason of or by use of its fiduciary position or through some opportunity or knowledge resulting from it."*[24]

The trustee's duties and responsibilities are outlined in the trust's documents (i.e. trust terms or trust deed) and under trust laws. They would generally include:

- Acting as a fiduciary, meaning that the trustee must not act to benefit themselves and must act in the best interests of the beneficiaries and the trust;
- Acting in good faith, meaning that the trustee must act with honesty, sincerity and retain fidelity to the beneficiaries and the trust;
- Preserving trust property, meaning that the trustee should safeguard trust assets; and
- Keeping trust records, which may include accounts and supplying information to a beneficiary upon request.

In a modern trust deed, the trustee's discretion would generally be expressed as being 'absolute and unfettered'. For example, consider the following clause:

> *Every discretion power or right hereby conferred on the Trustees is an absolute and uncontrolled discretion power or right and may be exercised without the intervention or approval of the Appointor or any of the Beneficiaries.*

The decisions in *Karger v Paul*[25] and *Owies & Owies v JJE Nominees Pty Ltd*[26], however, illustrate that—notwithstanding a broad discretion granted to the trustee—the trustee still has a fiduciary duty to the trust and its beneficiaries. The trustee must exercise a discretion conferred upon it —even one described as 'absolute and unfettered'—in good faith, upon real and genuine consideration and in accordance with the purposes for which

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[21] *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 at 68; *Wright v Lemon (No 2)* [2021] WASC 159 at [304]; *Brady Street Developments Pty Ltd v M E Asset Investments Pty Ltd* [2013] NSWSC 1755 at [55].

[22] *Beach Petroleum NL v Kennedy* (1999) 48 NSWLR 1 at 46-7.

[23] (2017) 54 VLR 625.

[24] See [119] of *Adventure Golf Systems*.

[25] (1984) VR 161.

[26] [2022] VSCA 142.

the discretion was conferred. In instances where this has been undertaken, it is then not up to the court to decide how that discretion should be exercised.

***Karger v Paul* [1984] VR 161**

***Facts***

The plaintiff, Rita Rose Karger, sought relief against the defendant, who was the executor and trustee of her cousin's estate, after the defendant had transferred the entirety of the estate to the deceased's husband. This was despite the fact that the trustee had an "unfettered discretion to pay or transfer the whole or part of the capital of the estate" to the deceased's husband. In particular, the cousin's will provided the following:[27]

> *"3. I GIVE DEVISE AND BEQUEATH all my property both real and personal of whatsoever nature and wheresoever situate to my husband, the said ALFRED HENRY SMITH during his lifetime with power to my Trustees in their absolute and unfettered discretion and upon the request of my said husband to pay or transfer the whole or part of the capital of my said estate to the said Alfred Henry Smith for his own use absolutely.*

The plaintiff also sought relief against the second defendant, Barbara Karasinski, who was the executrix of the will of Alfred Henry Smith, the cousin's husband. Barbara had received the whole of his estate under that will. It was alleged that the second defendant took that estate, which included assets from the estate of the cousin Smith or money representing those assets, with notice of all material facts.

***Issues***

Karger sought to impugn the discretion, on the basis that it had not been improperly exercised. Specifically, she contended that the defendant had *"acted wrongly in doing so and deprived her of her entitlement under the will. It is alleged that the executors acted wrongly in paying and transferring the estate because in doing so they did not act honestly and in good faith, they acted without any fair and proper consideration as to whether they should do so and they therefore acted in breach of trust."* [28]

***Outcome***

The Supreme Court of Victoria considered that the defendant had exercised its discretion honestly and in good faith. On that basis, the plaintiff's case was dismissed. The following statements from the Court are notable:

> *"In my opinion the effect of the authorities is that, 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."*[29]

> *"For the plaintiff it was submitted that in this case the Court should examine whether the trustees gave fair and proper consideration to the exercise of the discretion and that the plaintiff should succeed in the action if they did not. In my view, in this case it is open to the Court to examine the evidence to decide whether there has been a failure by the trustees to exercise the discretion in good faith, upon real and genuine consideration and in accordance with the purposes for which*

[27] See 163 of *Karger v Paul*.

[28] See 163 of *Karger v Paul*.

[29] See 163 of *Karger v Paul*.

> *the discretion was conferred. 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 that 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 examined 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.*[30]

### *Owies & Owies v JJE Nominees Pty Ltd* [2022] VSCA 142

#### *Facts*

*Owies* concerns a series of annual trust distributions made by the trustee of a discretionary trust called the Owies Family Trust. This trust was settled by deed in 1970 for the benefit of the Owies family, being Dr John and Dr Eva Owies and their three adult children: Michael, Deborah and Paul.

The trustee was a company, JJE Nominees Pty Ltd. Dr John and Dr Eva Owies were directors of the trustee from registration until they passed away in 2020 and 2018 respectively. They were replaced by Michael (appointed as director of the trustee on 20 November 2019) and Mr Sampson, their solicitor (appointed as a director of the trustee on 10 March 2020).

The primary beneficiaries of the Owies Family Trust were described as the children of Dr John and Dr Eva Owies, so their three adult children: Michael, Deborah and Paul. The beneficiary class of the trust therefore included all 5 of the family and their relatives—a narrow class of beneficiaries.

During the income years ending 30 June 2011 to 30 June 2019, 100% of the trust's distributable income was distributed only to Dr John and Dr Eva Owies and Michael (except for one year where 100% of the income was distributed to Dr John Owies). During this period, Dr John and Dr Eva Owies were estranged from Deborah and Paul.

#### *Issues*

Deborah and Paul sought and contended the following:

1. The trustee had failed to give real and genuine consideration to their position as beneficiaries during the relevant years (being the 2015 to 2019 income years) in exercising its discretion to distribute income;
2. As a result, the distributions should be set aside because they are void or invalid;
3. Each of Paul and Deborah should be given one-third share of the trust net income for those years; and
4. The trustee should be removed and an independent trustee appointed in its place.

The capacity for the trustee to make such discretions were ostensibly permitted by the broad allowances in the trust deed:

[30] See 164 of *Karger v Paul*.

> *"[Clause 3] The Trustees shall in each accounting period until the Vesting Day pay apply or set aside the whole or such part (if any) as they shall think fit of the net income of the Trust Fund of that accounting period for such charitable purposes and/or to or for the benefit of or for all or such one or more exclusive of the others or other of the General Beneficiaries living from time to time in such proportions and in such manner as the Trustees in their absolute discretion and without being bound to assign any reason therefor (but after considering the wishes of the Guardian) shall think fit.*[31]
>
> *[Clause 17] every discretion vested in the Trustees shall be absolute and uncontrolled and every power vested in them shall be exercisable at their absolute and uncontrolled discretion."*[32]

***Outcome***

The Supreme Court of Victoria acknowledged that the exercise of a discretion by the trustee cannot be impugned on the basis that the decision was unfair, unreasonable or unwise. However, following *Karger v Paul*, it is open to the court to consider whether the trustee had taken a 'properly informed consideration'.

Deborah and Paul were successful in arguing that the income distributions during the relevant years were *voidable* (though not void) on the basis that the trustee, in making the decision to distribute income, had not given real and genuine consideration of them as potential beneficiaries. In particular:

- The trustee had made no enquires of Paul and Deborah's circumstances. This was because in some years there was no contact with them and in others, there was minimal contact and no evidence of enquiries;
- The fact that the distributions were repeatedly made in the exact same proportion each year (except 2019) to the three primary beneficiaries (of 40%, 40% and 20% respectively) strongly indicated a lack of consideration of Deborah's position, who was in a parlous health and financial situation. This is particularly notable in light of the purpose of this trust, which was to provide for the beneficiaries in the context of a family settlement—although the deed did not require the trustee to distribute based on need;
- Whilst the trustee was required to take into account the wishes of the guardian (being Dr John Owies), the trustee was also required to exercise an independent mind—in recognition of the fact that the interests of the guardian are not always consistent with the best interests of the beneficiaries (towards whom the trustee owes a duty). In this regard, there was a history of antipathy (or hostility) between Dr John and Dr Eva Owies with Deborah, that was reflected in the dealings with the trust; and
- It could be inferred: "*from the outcome of the 2018 distributions that the trustee had, by that time, reached a policy of distributions with a settled ratio that was inconsistent with a continuing obligation to consider the distribution of income for each accounting period. In 2019 that pattern altered but not in a way that pointed to any real and genuine consideration of Paul or Deborah. The judge was correct to view each year separately but, in our respectful view, that came at the cost of understating the overall picture discernible from the pattern of distributions as a whole*."[33]

As the distributions were voidable rather than void, they remained in effect. The court also agreed to remove the trustee and have an independent trustee appointed in substitution.

[31] See [22] of *Owies*.

[32] See [24] of *Owies*.

[33] See [125] of *Owies*.

The following quotes from the decision are particularly notable:

> *"In Attorney-General (Cth) v Breckler, the High Court adopted the following summary of principle: Where a trustee exercises a discretion, it may be impugned on a number of different bases such as that it was exercised in bad faith, arbitrarily, capriciously, wantonly, irresponsibly, mischievously or irrelevantly to any sensible expectation of the settlor, or without giving a real or genuine consideration to the exercise of the discretion. The exercise of a discretion by trustees cannot of course be impugned upon the basis that their decision was unfair or unreasonable or unwise. Where a discretion is expressed to be absolute it may be that bad faith needs to be shown. The soundness of the exercise of a discretion can be examined where reasons have been given, but the test is not fairness or reasonableness."*[34]
>
> *"There is no doubt that under Karger v Paul principles, particularly as they have been applied to superannuation funds, the decision of a trustee may be reviewable for want of 'properly informed consideration'. If the consideration is not properly informed, it is not genuine. The duty of trustees properly to inform themselves is more intense in superannuation trusts in the form of the Deed than in trusts of the Karger v Paul type: from the High Court decision in Finch v Telstra Super Pty Ltd."*[35]
>
> *"In the case of some trusts, the number of potential objects might be very large and a requirement to undertake a detailed analysis of the identity and needs of each would be unworkable. Having considered whether or not to exercise the power and understood the range of objects that might benefit, the trustee is required to give* adequate *consideration as to how to exercise the power."*[36]
>
> *"In Re Hay's Settlement Trusts, Megarry VC said: The trustee must not simply proceed to exercise the power in favour of such of the objects as happen to be at hand or claim his attention. He must first consider what persons or classes of persons are objects of the power within the definition in the settlement or will. In doing this, there is no need to compile a complete list of the objects, or even to make an accurate assessment of the number of them: what is needed is an appreciation of the width of the field, and thus whether a selection is to be made merely from a dozen or, instead, from thousands or millions. … Only when the trustee has applied his mind to the 'size of the problem' should he then consider in individual cases whether, in relation to other possible claimants, a particular grant is appropriate. In doing this, no doubt he should not prefer the undeserving to the deserving; but he is not required to make an exact calculation whether, as between deserving claimants, A is more deserving than B."*[37]
>
> *"Although the validity of the outcome of an exercise of power is not to be assessed by notions of fairness or reasonableness, the process must be one in which the trustee is able to exercise the power in a manner that is just, in the sense of it not being arbitrary or capricious, and it must accord with the purpose of the trust. Often that will require ensuring that the trustee is adequately informed so as to put itself in a position to properly exercise the power. As Callaway JA said in Telstra Super Pty Ltd v Flegeltaub, 'one cannot ordinarily decide a question of fact in good faith and give it real and genuine consideration without conducting some investigation and in some cases that will entail making an inquiry of a person who is willing to provide information and is in the best position to do so. It is not a matter of natural justice but bona fide inquiry and genuine decision making.'"*[38]

[34] See [87] of *Owies*.

[35] See [92] of *Owies*.

[36] See [95] of *Owies.*

[37] See [96] of *Owies.*

[38] See [97] of *Owies*.

*"Given its terms, it would have been expected that the class of general beneficiaries would not be particularly large and would continue to revolve around the three Owies children. An obvious, but unstated, premise on which the trustee would be expected to discharge its duties is that it would generally be informed about the differing circumstances, needs and desires of each beneficiary as an incident of the familial bonds that underpin the trust and explain its purpose. It is not to be supposed that, when those familial bonds become strained or broken, the purpose of the trust to provide for the family as a whole would change or that the trustee would be relieved of the obligation to properly inform itself."*[39]

[39] See [111] of *Owies*.

# 5. Why a family discretionary trust?

A family discretionary trust is commonly put forward because of one or more of the following benefits: tax efficiency, asset protection and/or succession planning. These are examined further below.

## 5.1 Tax efficiency

Trusts are taxed under Division 6 of Part III of ITAA 1936. The core principle of trust taxation is that a beneficiary who is 'presently entitled' to a share of trust income is responsible to pay tax on that income at their marginal tax rates.[40] Therefore, a family discretionary trust is commonly described as conducive of tax efficiency because it provides the trustee with flexibility to allocate income of the trust between the class of beneficiaries. The primary tax benefits are:

- ***Income splitting:*** an opportunity to split income between several beneficiaries, having regard to their individual circumstances and marginal tax rates. On this basis, the trust facilitates an allocation of income to 'lower-taxed' taxpayers, such as a family member or a bucket company; and
- ***Income streaming:*** an opportunity to allocate (or stream) franked dividends and capital gains to different beneficiaries to take advantage of varying tax treatments. For example, franked dividends may be streamed to a foreign beneficiary, such that no further tax is payable (as compared to a distribution of the franked dividends to a tax resident beneficiary), and capital gains may be streamed to beneficiaries who have capital losses or can access capital gains tax (**CGT**) concessions, such as the CGT discount.

## 5.2 Asset protection

A family discretionary trust can provide a degree of asset protection, given their design that the beneficiaries are not legally entitled to trust income and assets until such time as the trustee having exercised its discretion in favour of the beneficiary. In particular, the general principles are:

- Property of a bankrupt at the time that the person becomes a bankrupt passes to the trustee in bankruptcy;[41]
- Property held on trust by the bankrupt, however, is not property that is 'divisible amongst creditors';[42]
- The appointor's power to appoint, replace or remove a trustee is not property that vests in a trustee in bankruptcy;[43] and
- The trustee in bankruptcy is not in a different position as a bankrupt beneficiary and cannot require the trustee of a discretionary trust to distribute trust assets unless a beneficiary has pre-existing (or fixed) entitlement to trust income and/or assets.[44]

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[40] On the other hand, any undistributed income of the trust will generally be taxed in the hands of the trustee at the highest marginal tax rate.

[41] Section 116(1) of the *Bankruptcy Act 1966* (Cth).

[42] Section 116(2) of the *Bankruptcy Act 1966* (Cth).

[43] *Re Burton; Wily v Burton* [1994] FCA 1146.

[44] *Fordyce v Ryan* [2016] QSC 307.

## 5.3 Succession planning

A family discretionary trust can have a place in a family's succession plan.

The family discretionary trust can be used to accumulate family wealth over time in a tax friendly and asset protective environment. Control of that wealth can be passed to the next generation, whilst the principal(s) of the family are still alive (i.e. the wealth is not passed through their estate, as assets of the trust do not generally form part of the estate of an individual). The passing of such control would not otherwise incur the transactional tax costs that usually apply to a transfer of legal and beneficial ownership in assets.

This strategy can be used to allow the principal(s) of a family to take a step-back in managing the trust, allow the next generation to take a more pro-active role in managing the trust and for the principal(s) to observe whether the next generation may (or may not) work well together as a family unit. This in turn can assist the principal(s) in formulating their broader estate plan, including whether to provide each of their children with separate and not jointly-held inheritances.

The trust terms may also be varied and the beneficiary class may be narrowed or widened to cater for the family's succession plan, bearing in mind the risks of a trust resettlement.

# 6. Why not a family discretionary trust?

Notwithstanding the benefits that generally come with a family discretionary trust, it is not always the most appropriate vehicle to achieve a family's broader investment and succession objectives. There can be situations where the family discretionary trust results in an unfavourable tax outcome. There can also be situations where asset protection become undone. It cannot be assumed that the family discretionary trust will always be an appropriate vehicle, and that a standard form trust will be fit-for-purpose.

## 6.1 Tax inefficiency

Situations where use of a family discretionary trust has resulted in an unfavourable tax outcome include the following. Some of these pitfalls appear obvious, however, in practice, I have encountered these time and time again. This shows that family discretionary trusts are being established without further thought being given to their suitability:

- The family home is held in a family discretionary trust, which results in loss of the CGT main residence exemption and land tax principal place of residence exemption. This often results in substantial costs to the client, both in terms of ongoing costs in owning the property and costs of unwinding the structure. The trust is often used in this scenario because of asset protection, but it is questionable whether the risk to asset protection is real and whether an alternative strategy (such as a gift and loan back arrangement) would be more appropriate and tax efficient.

- Land tax costs of using a family discretionary trust to acquire real estate: a discretionary trust is generally not eligible for the land tax threshold (e.g. in NSW, it would generally be classified as a special trust). This means that the land tax costs of holding real estate can be higher with a discretionary trust. More recently, I've encountered situations where the trust does not have a 'foreign beneficiary' exclusion clause, or an appropriately drafted clause, leading to the Revenue Office issuing substantial land tax assessments spanning multiple land tax years for the land tax surcharge. This could be avoided with simple advice at the time of establishing the trust.

- The trust is used to derive personal services income—being income that is mainly a reward of an individual's personal efforts or skills—and as a result of the application of the PSI rules in Division 86 of the *Income Tax Assessment Act 1997* (Cth), the income is taxed at the marginal tax rates of the individual (i.e. there is no tax flexibility to distribute the income). As the trust was intended to only provide flexibility in distributing income and served no other purpose,[45] the benefit of using the trust is questionable. Note that even if the PSI rules do not apply, the ATO's guidance in PCG 2021/4 and PCG 2024/D2 should be considered.

- A 'negatively geared' trust: the trust is used to acquire assets, such as real estate, and will generate a net income loss for years to come. As the losses are derived by the trust, they are quarantined within the trust. As there are no other income of the trust, the losses would not be utilised for years to come.

- The trust is used in schemes that are blatantly tax driven and fall foul of the ATO's guidance in matters relating to section 100A and Part IVA of the ITAA 1936. Consider the arrangement described in Taxpayer Alert 2022/1: Parents benefitting from the trust entitlements of their children over 18 years of age (see Annexure A.1, Step 7 for a discussion on this taxpayer alert).

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[45] Particularly in circumstances where the trust holds no assets, apart from an interest in the business, and the individual is directly exposed to risks of the business through the giving of guarantees to creditors and are exposed to personal liability as a director in relation to PAYG withholding, SGC obligations and unpaid GST.

## 6.2 Asset protection becoming undone

Notwithstanding general asset protection benefits, there have been cases where the courts have been willing to pierce the veil of the trust and attribute the trust fund to a beneficiary of the trust. This occurred in the decisions of *Richstar Enterprises*[46], *Faucilles*[47] and *Kennon v Spry*[48].

***Australian Securities and Investments Commission In the Matter of Richstar Enterprises Pty Ltd (ACN 099 071 968) v Carey (No 6)*** **[2006] FCA 814**

***Facts***

*Richstar* relates to orders sought by the Australian Securities & Investments Commission (**ASIC**) in respect of property of an individual (a property developer). ASIC had sought to bring the scope of receiver orders property held by trusts in which the defendant was a beneficiary.

***Issues***

Whether assets held within a family discretionary trust may be the subject of a property order imposed upon an individual, who is a potential beneficiary, in the context of a bankruptcy action.

***Outcome***

Justice French found that the property of the trust was 'owned' by the investigated individual, on the basis that he was *"the effective controller, enjoying at least a contingent interest"* in that property per the Corporations Act. The orders sought by ASIC in respect of the property within the trust was thus granted, despite the fact that the relevant individual was only one of two directors of the corporate trustee, and one of two joint appointors to the trust. This was previously considered to be sufficient asset protection.

This decision produced what is known as the '*alter ego principle'*. This stipulates that where a discretionary trust is in fact the alter ego of an individual, the assets of the trust may be attributed as property of that person. This is on the basis that it is 'as good as certain' that the beneficiary will receive the benefits of distributions.

The following quotes from Justice French are notable:

> *"5. … I am prepared to make more specific orders than that sought in par 3.6 directed to the class of discretionary trusts in which, because the trustee is effectively the alter ego of the relevant beneficiary or otherwise subject to his or its effective control, the beneficiary has at least a contingent interest within the meaning of that term as used in the definition of 'property' in s 9 of the Act."*

> *"29. … in the ordinary case the beneficiary of a discretionary trust, other than perhaps the sole beneficiary of an exhaustive trust, does not have an equitable interest in the trust income or property which would fall within even the most generous definition of 'property' in s 9 of the Act and be amenable to control by receivers under s 1323. I distinguish the 'ordinary case' 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."*

> *"36. The difficulty with applying the notion of contingent interests to beneficiaries of a discretionary trust lies partly in the uncertain scope of the distribution be it income or capital, which may be made in favour of any given beneficiary. I am inclined to think that a beneficiary in*

[46] [2006] FCA 433.

[47] (1989) 90 ATC 4003.

[48] [2008] HCA 56.

*such a case, at arms length from the trustee, does not have a 'contingent interest' but rather an expectancy or mere possibility of a distribution. In some discretionary trusts, and there is an example among those of which Mr Beck is a beneficiary, charities as a class are included in the class of beneficiaries. It could hardly be said that every charity in Australia has thereby acquired a contingent interest in that trust. On the other hand, where a discretionary trust is controlled by a trustee who is in truth the alter ego of a beneficiary, then at the very least a contingent interest may be identified because, to use the words of Nourse J, 'it is as good as certain' that the beneficiary will receive the benefits of distributions either of income or capital or both.*

*37. As discussed earlier, the 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. There are cases in the Family Law jurisdiction which have dealt with like circumstance. In Ascot Investments Pty Ltd v Harper (1981) 148 CLR 337, Gibbs J said (at 354-355):*

> *'… 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.'*
>
> *Stephen, Aickin and Wilson JJ agreed.*

*38. The Full Court of the Family Court of Australia in In the Marriage of Ashton (1986) 11 Fam LR 457 considered a case in which the husband was appointor of a family trust. He had the power to remove and appoint the trustee and could appoint himself. The trustee had the power to alter the terms of the trust at will. He was not a beneficiary of the trust but had received income from it. He was found to be 'in full control of the assets of the trust'. There were 'good grounds for saying the trust is no more than the husband's alter ego'. Strauss J said (at [14]):*

> *'In the result, having regard to the powers and discretions which the husband has, and having regard to what had in fact taken place, for the purposes of s 79 [of the Family Law Act 1975 (Cth)], the husband's power of appointment, and all the attributes it carries with it, amounts to de facto ownership of the property of the trust.'"*

The primary indicator of an alter ego arrangement is accordingly effective control over the trustee's power of selection, and/or the power to appoint a new trustee, as these create what is 'akin to a proprietary interest'.

Whilst the alter ego principle applied in *Richstar* was affirmed to be correct in the appellant decision of the full court of the Family Court in *Daniels v Bell*[49], courts have subsequently criticised *Richstar* and demonstrated a reluctance to follow its principle.

- *Simmons and Anor & Simmons*[50] – the court and parties in this case referred to *Richstar* on several occasions, and confirmed that a beneficiary of a discretionary trust possesses nothing more than an expectancy in relation to trust property.
- *Public Trustee v Smith*[51] – the court in this case reiterated the priority importance of the terms of the trust deed, clarifying that *Richstar* did not establish that merely because a beneficiary controls

[49] [2007] FamCA 152 (2 March 2007).

[50] [2008] FamCA 1088.

[51] [2008] NSWSC 397.

the appointment or removal of the trustee or the trustee's power, that the holder of such power is the beneficial owner of the trust property irrespective of the deed.

- *Hja Holdings Pty Ltd and Ors & Act Revenue Office (Administrative Review)*[52] – the court reiterated the position that, generally, a beneficiary of a discretionary trust only has an expectancy or mere possibility of a distribution distinct from an equitable interest in property.
- *Donovan v Sheahan as Trustee of the Bankrupt Estate of Donovan*[53] – the court emphasised that the essential right of the beneficiary in relation to a discretionary trust is the negative right to compel due administration; in contrast, the beneficiary of a discretionary trust does not possess a positive right to demand payment of the trust fund.

- *Fordyce v Ryan*[54] – the court held that *Richstar* only dealt with the meaning of 'property' for the purposes of section 9 of the Corporations Act, and not the Bankruptcy Act (at issue in this case). In declining to extend the *Richstar* principle to claims arising from the Bankruptcy Act, this case provides further buttressing against the veil-piercing implications of *Richstar.* Though *Richstar* was thus not directly at issue in this case, Jackson J also expressed the following view:

  *"It is difficult to accept as a principle of reasoning that a beneficiary's legal or de facto control of the trustee of a discretionary trust alters the character of the interest of the beneficiary so that it will constitute property of the bankrupt if the beneficiary becomes a bankrupt. To the extent that Richstar might be thought to support such a principle, it has not been followed or applied subsequently and it has been criticised academically… In my view, there is no general principle of law of that kind."*[55]

- *Swishette Pty Ltd v Australian Competition and Consumer Commission*[56] – the court confirmed that the beneficiary of a discretionary trust has no legal or beneficial interest in the assets of that trust, but only the right to due consideration and due administration of the trust. It also noted that the fact that someone may control a trust both as appointor and as director of the trustee company, does not give them an interest in the trust property amounting to ownership.

- *Pleash, in the matter of Equititrust Limited (In Liquidation) (Receivers and Managers Appointed) (No 3)*[57] – the court acknowledged that the reasoning in decisions such as *Swishette* (above) reject the arguments presented in *Richstar,* and should be followed as the correct approach in preference to the reasoning in *Richstar*.

Despite this reluctant treatment, *Richstar* has not been expressly overruled.

[52] [2011] ACAT 91.

[53] [2013] FCA 437.

[54] [2016] QSC 307.

[55] See [37] of *Fordyce*.

[56] [2017] FCAFC 45.

[57] [2017] FCA 1074.

***Faucilles Pty Ltd v Federal Commissioner of Taxation* (1989) 90 ATC 4003**

Distinct from the alter ego trust argument from *Richstar*, the decision in *Faucilles* challenges the asset protective function of trusts via the sham principle. This principle relies on the assertion that arrangements in place are not real, are not of real substance and are a mere façade.

***Facts***

The case concerns a discretionary family trust known as the John Kakridas Family Trust No. 2. The trust nominated non-resident relatives of Mr Kakridas as beneficiaries (such that they were takers-in-default of income of the trust).

***Issues***

The Commissioner contended that the establishment of the trust was a sham, and that the nomination of the non-resident beneficiaries under the trust and the distributions purportedly made by the trustee to non-resident beneficiaries and the loans purportedly made back by those non-resident beneficiaries were shams.

This was on the basis that there was no intention that the trustee would hold income received for the benefit of the non-resident beneficiaries or that the loans would be made by those non-resident beneficiaries, both inferred on the following basis:

a) there were no contemporaneous documents evidencing the supposed distribution of income from the John Kakridas Family Trust No. 2;

b) there were no contemporaneous documents evidencing the loans back by non-resident beneficiaries of the supposed distributions of income;

c) there were no documents, contemporaneous or otherwise, evidencing the order of the supposed distributions and loans back;

d) acknowledgements of distribution and authorities to lend supposedly signed by the non-resident beneficiaries but were forgeries created after the event;

e) the non-resident beneficiaries did not at any relevant time have any knowledge of the existence of the supposed John Kakridas Family Trust No. 2 or of their supposed entitlements under that trust;

f) the non-resident beneficiaries did not at any relevant time know that moneys the subject of distributions supposedly made to them were loaned back to the trustee;

g) none of the distributions supposedly made to the non-resident beneficiaries were ever paid to the non-resident beneficiaries;

h) the moneys the subject of the supposed distributions have been invested in the acquisition of assets in the name of John Kakridas, for his own benefit.

Instead, the Commissioner contended that the true intention underlying the establishment of the trust was that the trustee would accumulate income and pay or apply it at some time (not specified) to the true beneficiary, Mr Kakridas or other members of his family.

***Outcome***

The Federal Court agreed with the Commissioner. Hill J, in particular, made the following observation:

> *For a transaction to be a sham there must be an intention common to the parties to it that the transaction is a cloak or disguise for some other and real transaction, or sometimes as in*

> *Clyne v. F.C. of T. 83 ATC 4508 for no transaction at all. It is, as Lockhart J. pointed out in Sharrment Pty. Ltd. v. Official Trustee in Bankruptcy (1988) 18 F.C.R. 449 at p. 454 something which is not genuine or true but false or deceptive. Where it is alleged that the trusts of a settlement or some of them are a sham, of necessity it will need to be proved that it was the intention of the settlor that the settlement itself be a sham, or in a case such as the present that some of the trusts of that settlement are a cloak or disguise for the real trusts intended to bind the trustee. Commr of Stamp Duties (Qld) v. Jolliffe (1920) 28 C.L.R. 178 at p. 181 is clear authority, if authority be needed, for the principle that intention is a necessary ingredient in the establishment of a valid express trust.*
>
> *The Tribunal found, and it was open for it so to find, that the settlement was brought about by Mr Kakridas; that he ``caused'' it to be made. That fact, coupled with the fact that Mrs Sztainbok [the settlor of the trust] was the wife of the tax accountant to Mr Kakridas and could be expected to give effect to her husband's client's wishes, plus the inference which could properly be drawn from their failure to give evidence that the evidence of the accountant and his wife would not assist the taxpayer, was sufficient in my opinion to permit the Tribunal to draw an inference as to the intention of Mrs Sztainbok and thereby justify the conclusion reached by the Tribunal that Mrs Sztainbok, like Mr Kakridas, did not intend that the default distribution provision would be effective.*

The principles in *Faucilles* have generally been accepted.[58]

### *Kennon v Spry* [2008] HCA 56

Where *Richstar* and *Faucilles* respectively dealt with the asset protective function of trusts in bankruptcy and sham contexts, *Kennon v Spry* addresses the trust in a family law context.

#### *Facts*

Prior to getting married, Dr Spry had set up a discretionary trust (the ICF Spry Trust), of which he was the trustee and entitled to vary the terms of the trust at any time. The beneficiaries were himself, his siblings, and the children (and their spouses) of each of them. By two amendments, both Dr Spry and his wife (Mrs Spry) were excluded from the list of beneficiaries. The latter of these amendments was effected after Dr Spry and his wife had separated in the context of marital troubles. Dr Spry subsequently took steps to split (that is, to segregate the assets of) what was in the initial family trust and create four separate sub-trusts for each of the four daughters of the relationship. In the court's view, Mr Spry's intention in doing so was to evade a family court order in relation to the assets originally held in the ICF Spry Trust by ensuring that:

1. he did not hold the assets (such as to be subject to giving them up to his wife), and
2. his wife did not hold the assets.

Mrs Spry then filed an application in the Family Court of Australia seeking orders for property settlement pursuant to section 79 of the *Family Law Act 1975* (Cth), which allows a court to make orders as it considers appropriate in altering the interests of the parties to the marriage in property. This decision was handed down following an appeal to the High Court of Australia.

#### *Issues*

Relevantly, two of the issues considered in this case were as follows:

[58] *Raftland Pty Ltd v Commissioner of Taxation* [2007] FCAFC 4,

1. Is the property of a wholly discretionary trust property capable of being subject to an order pursuant to section 79?
2. Did the amendment of the trust deed to remove both the Dr Spry and his wife as beneficiaries have the effect of removing the property of the trust from property capable of being subject to an order pursuant to section 79?

***Outcome***

French CJ held that the property of the trust, and the beneficiaries' right to due administration of the trust, constitute property for the purposes of section 79, except where the trustee embroiled in section 79 proceedings clearly only held a mere legal title (such as a trustee of a charitable trust or executor of a friend's will). His Honour stated:

> *"66. For so long as Dr Spry 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."*

Gummow, Hayne and Keifel JJ held that the property was the right to due administration of the trust and that where due administration of the trust included the power to distribute the entirety of the trust property to either spouse as beneficiary, then the value of that right constituted the value of the trust property.

The attempted trust split was ignored, such that the assets that had otherwise been given over to the control and benefit of the four daughters were returned back to the trust, control of which was deemed to lie solely with Dr Spry.

The assets originally held in the ICF Spry Trust could thus be administered under the terms of the family court order and pass entirely to the benefit of Mrs Spry.

## 6.3 Succession disputes

As highlighted in *Owies*, a family discretionary trust is not always the best vehicle to facilitate a family's succession plan. In that decision, the wealth of Dr John and Dr Eva Owies were intended to be passed to Michael. However, the plan came undone as the trustee did not take care with its duty to the trust and beneficiaries.

Whilst in a 'happy family' situation, this issue may not arise (as no beneficiaries would challenge the decisions of the trustee), it still leaves a potential challenge over time as relationships fluctuate and the mix of beneficiaries change.

Alternative strategies may include the following:

- Draining the trust and its assets so that the assets pass through the estates of Dr John and Dr Eva Owies to Michael or a testamentary trust designed around Michael. It is acknowledged that this could have tax costs (such as capital gains tax and stamp duty in distributing assets of the trust to Dr John and Dr Eva) and any potential challenge to the estates of Dr John and Dr Eva Owies should be considered and managed. Further, the trustee's decision to distribute the trust fund can be found to be void on the basis of no real and genuine consideration;
- The trustee properly exercising any discretion to exclude or remove disaffected beneficiaries. However, note that such decision can be found to be void on the basis of no real and genuine consideration;

- Expanding the beneficiary class, as the *Owies* decision was based on a narrower class of beneficiaries. However, it is likely that there is still an obligation to consider the core beneficiaries;

- Amending the deed to remove the disaffected beneficiary as a primary or default beneficiary, as the court in *Owies* appeared to have put weight on the fact that the children were the primary beneficiaries, as compared to the parents. However, query whether this may give rise to a trust resettlement; and

- Implementing a formal claim-staking process each year, where the trustee enquires about the beneficiaries' situations and needs—perhaps by inviting beneficiaries to provide an update of their circumstances. As noted in *Karger v Paul* and *Owies*, the exercise of a discretion in these terms will not be examined or reviewed by the courts so long as 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.

# 7. Designing the family discretionary trust

Where the family discretionary trust serves a purpose and provides a benefit to the family (including having a role to play in the family's ecosystem of investment vehicles), there is a question on how the trust should be designed.

These days, most modern trust deeds are provided in a standard form. Where there is an opportunity to design the trust, a trust deed that is tailored—even to a limited extent—can assist with enabling the trust structure to work more seamlessly with the family's broader investment vehicles and to achieve the family's objectives, including asset protection and succession planning motivations.

Appropriate design considerations will depend on the facts, including relationship dynamics of the family. Relevant considerations can include the following:

- ***Who should be the settlor:*** Apart from the guiding principle that the settlor cannot benefit from the trust, as this would lead to a revocable trust,[59] there is a question on who should be the settlor. Should it be: a stranger; a relative; a close family friend; or even the principal of the family? My personal preference is a close family friend who can genuinely say that it is their personal wish to establish the trust and to genuinely gift the settlement amount. Where a professional adviser, such as an accountant or lawyer is chosen, there can be questions on whether the settlement sum was genuinely gifted and whether the client may instead be the settlor in reality. In some circumstances, it may be appropriate that the settlor is the principal of the family—as this could give the trust a more personal and stronger purpose for succession planning purposes and provide arguably stronger asset protection.

- ***Who should be the appointor:*** As discussed earlier in the paper, the appointor is the person who is vested with the power to appoint and remove the trustee. Usually, the appointor is the person who had caused the trust to be established (not as the settlor, but the principal of the family or the client). In the context of succession planning, there is a question on who should become the successor appointor. Should the appointor be: one of the children, some of the children or all of the children? In a blended family relationship, having all children as joint appointors can be problematic or unworkable. Further, the succession provision in the trust deed may not be sufficiently comprehensive to deal with events such as the appointor passing away or losing capacity.

- ***The role of the appointor:*** In some trust deeds, the appointor's role is limited to appointing and removing the trustee. There is a question on whether the appointor role should be more active, rather than passive. If the view is taken that the appointor should be the 'guardian' who safeguards the trust and ensures proper administration of the trust, the appointor role should perhaps be expanded to require the trustee to consult with the appointor before exercising certain powers, such as distributing trust capital.

- ***Who should be the trustee:*** Having an individual (i.e. natural person) as a trustee generally provides simplicity, lower set up costs and higher levels of control. However, these benefits can be outweighed with a lack of asset protection, as the individual trustee may be held personally liable and their personal assets may be at risk to satisfy the trust's liabilities and the administrative burden of changing the trustee and transferring assets to the new trustee if the individual trustee is replaced (including by death or loss of capacity). Having a corporate trustee generally provides a greater degree of asset protection and ease of succession. However, there can be a question on how the shares in the company should be passed to the next generation (including whether special classes of shares should be issued to each of the family branch to ensure that they have a right to appoint a director) and whether (and how) the governing documents of the company should be tailored to suit the family's succession plan (including through the use of a shareholders' agreement or a family constitution).

[59] See section 102 of the *Income Tax Assessment Act 1936* (Cth).

- ***Beneficiary class:*** Relevant questions can include:
  - Should the beneficiary class be as broad as possible? Should the beneficiary class be narrow? The decision in *Owies* illustrates that the trustee has a duty to give 'real and genuine' consideration of the beneficiary class and that having a wider beneficiary class may require 'less' of the trustee in this regard. However, the decision in *Faucilles* shows how a whole class of beneficiaries could be nullified on the basis of sham.
  - Should the spouse be included as a beneficiary? What about a former spouse?
  - Should a step-child be included as a beneficiary?
  - In some trust deeds, a person (including an existing beneficiary) who makes a gift to a trust, transfers property at less than market value or makes an interest free loan to the trust can become a notional settlor and be excluded as a beneficiary. How is this appropriate?
  - Should there also be different categories of beneficiaries, such as those who can only benefit from trust income, those who can only benefit from trust capital and those who can benefit from all trust distributions?
  - In the context of succession planning of primary production land, the duty exemption in section 274 of the Duties Act 1997 (NSW) (also commonly known as the inter-generational farming duty exemption) requires the takers-in-default of a family trust to be members of the family and have at least 25% of interest in the capital of the trust.

  Investing time in considering the appropriate beneficiary class, including who may be intended to benefit, when they may benefit and whom should not definitely benefit can be a worthwhile exercise.

- ***Distribution mechanisms:*** Should the family discretionary trust remain wholly discretionary? Should there be an automatic split of income upon a trigger event, such as the passing of the principal of the family or where a dispute amongst the family members cannot be resolved by unanimous agreement? This could avoid the situation where 'one side' of the family controls the trust and refrains from distribution an equal share to the 'other side' of the family, such as the *Owies* situation.

# 8. Distributing annual trust income

When the time comes for a trustee to exercise its discretion to distribute annual income of the trust, which is generally required to take place on or before 30 June of the income year, there are a range of matters that should be considered by the trustee.

These matters include both tax and trust law considerations. If a trustee only turns their mind to tax matters, then they may fall foul of trust law considerations, such as giving 'real and genuine consideration' of the beneficiary class as illustrated in the *Owies* decision. Likewise, if a trustee only turns their mind to trust law considerations but ignore the possible tax outcomes, then a distribution may be made in a way that is not tax efficient for the beneficiary—e.g. a capital gain that attracts the CGT discount is distributed to a company controlled by an individual instead of being distributed to the individual personally, in circumstances where the individual will need the funds to meet personal expenses.

It is prudent that a trustee has a checklist to guide them through the annual distribution process. This would reduce the risk of unexpected outcomes. Ideally, the checklist should be sufficiently comprehensive and include current matters on the ATO's radar, such as section 100A of the ITAA 1936. A sample checklist is provided in **Annexure A.1** and a current list of trust activities attracting the ATO's attention is provided in **Annexure A.2**.

# 9. Amendments to the trust deed

From time to time, amendments are made to the trust deed. There can be a number of reasons for making such amendments, including:

- Amendments that are administrative in nature, such as to expand existing trustee powers or provide new trustee powers. An example is to provide the trustee with a power to borrow money from an unrelated party to fund a proposed investment, where this power is not explicitly provided in the trust terms;
- To extend the vesting date of the trust, subject to the 'rule against perpetuities'; and
- Amendments that are more drastic in nature, such as to exclude beneficiaries or remove an appointor, for reasons that may be harmless (e.g. land tax purposes, or the appointor has passed away and there is a lack of an appropriate succession mechanism) or reasons that are more devious (e.g. a fight between family members for control of the trust).

With any proposed amendment of the trust terms, the starting position is to identify the power of amendment in the trust deed. This is because a trustee has no inherent power to amend the trust terms.

Absent a power of amendment in the trust deed, the terms of the trust may only be changed by the court. For example, section 86A of the *Trustee Act 1925 (NSW)* provides that the court may, if it thinks fit, by order approve any arrangement to:

- Vary or revoke all or any of the trust; or
- Enlarge the powers of the trustees for the purpose of managing or administering any of the property subject to the purpose of the trust.

Assuming that trust deed provides a power of amendment, it is important to construe it carefully, having regard to its scope and any conditions on its exercise. Guiding principles include the following:

- Understand the scope of the power of amendment. An amendment would only be effective if it is made within the scope of that power as expressed in the deed.[60] This is a question of construction—not only of the clause itself (including any express or implied limitations on the exercise of the power), but also on the trust instrument as a whole (including its underlying purpose and intention of the settlor);
- Consider whether there are any restrictive provisions in the trust deed. For example, the trust deed may specifically prohibit an extension of the vesting day of the trust, notwithstanding that the trust vests within a period that is less than 80 years. More recently, to meet NSW surcharge duty and land tax requirements, foreign beneficiary exclusion clauses are expressed as irrevocable;
- The following quote from the Supreme Court of Queensland in *Jenkins v Ellett*[61] provides a useful starting position:

> *The scope of powers of amendment of a trust deed is discussed in an illuminating fashion in Thomas on Powers (1st ed., 1998) at pp. 585-586, paras 14-31 to 14-32 in these terms: "In all cases, the scope of the relevant power is determined by the construction of the words in which it is couched, in accordance with the surrounding context and also of such extrinsic evidence (if any) as may be properly admissible. A power of amendment or variation in a trust instrument ought not to be construed in a narrow or unreal way. It will have been created in order to provide flexibility, whether in relation to specific matters or more generally. Such a power ought,*

[60] See discussion in *Pitt v Holt; Futter v Futter* [2012] Ch 132 at [96] (Lloyd LJ).

[61] [2007] QSC 154.

> *therefore, to be construed liberally so as to permit any amendment which is not prohibited by an express direction to the contrary or by some necessary implication, provided always that any such amendment does not derogate from the fundamental purposes for which the power was created. Thus, a power of amendment will undoubtedly be capable of making amendments which are essentially ancillary to, and for the better execution of, such fundamental purposes, e.g. so as to substitute an easier form of communication or service for the one originally stipulated, or so as to make other powers exercisable in writing rather than by deed, or, indeed, introduce other amendments which are not simply administrative or managerial in nature. It does not follow, of course, that the power of amendment itself can be amended in this way. Indeed, it is probably the case that there is an implied (albeit rebuttable) presumption, in the absence of an express direction to that effect, that a power of amendment (like any other kind of power) cannot be used to extend its own scope or amend its own terms. Moreover, a power of amendment is not likely to be held to extend to varying the trust in a way which would destroy its 'substratum'. The underlying purpose for the furtherance of which the power was initially created or conferred will obviously be paramount."*

- Also note the following helpful summary of the principles of amendment based on case law:[62]

  (a) fundamental provisions (e.g. the guardian or appointor powers and the amendment power itself) are generally incapable of amendment without specific authorisation in the trust instrument enabling amendment of the fundamental provisions: *Jenkins v Ellett supra; Mercanti v Mercanti*[63]*, though see on appeal.*[64]

  (b) ancillary provisions (e.g. form of exercise of powers and notice requirements) are generally capable of amendment under a general power of amendment: *Jenkins v Ellett supra*;

  (c) the trust instrument can expressly prohibit certain amendments entrenching the provision: *Jenkins v Ellett supra*;

  (d) the scope of a wide power of amendment may be read down having regard to the surrounding context of the trust instrument: *Duke of Bedford v Marquess of Abercorn (1836) 40 ER 394*;

  (e) a properly drafted trust instrument can permit retrospective amendment: *Gra-Ham P/L v Perpetual Trustees WA Ltd (1989) 1 WAR 65; Global Custodian Ltd v Mesh [1999] NSWSC 624 at [67]*;

  (f) the exercise of the power must comply with any restrictions on the exercise of power including any requirement for consent by an appointor or a guardian: *Re Cavill Hotels Pty Ltd [1998] 1 Qd R 396*; and

  (g) an amendment will be invalid and ineffective if:

    a. if it is not within the scope of any evidence purpose of the power of amendment: *Kearns v Hill (1990) 21 NSWLR 107 at 110; Re UEB Industries Ltd Pension Plan (1992) 2 NSLR 294*; or

    b. the amendment would destroy any evident substratum of the trust: *Kearns v Hill (1990) 21 NSWLR 107 at 111*.

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[62] This list is provided in the paper of Michael Bennett, *Trust Deeds: Drafting, Varying and Getting It Right,* 3 April 2017 and Ron Jorgensen, *Managing Trust Deed Amendments,* 10 April 2016.

[63] [2015] WASC 297.

[64] [2016] WASCA 206.

# 10. Resettlement of the trust

## 10.1 Tax consequences of a trust resettlement

Trust resettlement is one of the most significant risks to be managed in administering a trust. This is because a trust resettlement can give rise to costly income tax and duty consequences, particularly the following:

- CGT consequences on creating a trust over a CGT asset (event E1) or transferring a CGT asset to a trust (event E2):
  - Where CGT event E1 occurs, a capital gain is made where the capital proceeds from the creation are more than the cost base of assets and a capital loss is made where those capital proceeds are less than the reduced cost base of assets;[65]
  - Where CGT event E2 occurs, a capital gain is made where the capital proceeds from the transfer are more than the cost base of assets and a capital loss is made where those capital proceeds are less than the reduced cost base of assets;[66] and
- Duty on declaration of a trust, transfer duty and/or trust acquisition/surrender duty, which give rise to duty based on dutiable value of the dutiable assets.[67] Currently, the highest duty rate is in Victoria at 6.5%.

## 10.2 When can a trust resettlement happen?

As a general principle, a trust resettlement occurs where property that is the subject of a trust becomes the subject of another trust, such that there is a new charter of rights and obligations in relation to that property.[68]

The leading authority on when a trust resettlement occurs is *Commissioner of Taxation v Commercial Nominees of Australia Limited*,[69] which dealt with a superannuation fund but has been endorsed by the Full Federal Court of Australia in *Clark v Commissioner of Taxation*[70] in the context of trusts.

Following *Commercial Nominees* and *Clark*, the position is 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 (as discussed earlier in this paper) will not have the result of terminating the trust. This is accepted by the Commissioner in Taxation Determination TD 2021/21.[71] In TD 2021/21, the Commissioner also indicates that, following *Clark*, continuity of a trust estate will be maintained so long as the trust is not terminated for trust law purposes,[72] and continuity of a trust is a function of whether the trust continues in existence under trust law.[73]

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[65] Section 104-55 of the ITAA 1997.

[66] Section 104-60 of the ITAA 1997.

[67] Consider section 9 of the *Duties Act 1997* (NSW).

[68] *Davidson (Collector of Imposts) v Chernside* (1908) 7 CLR 324 at 340-341 (Griffiths CJ).

[69] (2001) 75 ALJR 1172.

[70] [2011] FCAFC 5.

[71] See paragraph [21] of Taxation Determination TD 2021/21.

[72] See paragraph [20] of Taxation Determination TD 2021/21.

[73] See paragraph [23] of Taxation Determination TD 2021/21.

To determine whether there is a resettlement for income tax purposes, the court in Commercial Nominees identified the 'three main indicia of continuity' are:

- the constitution of the trusts under which the trust operates;
- the trust property; and
- the membership of the trust.

Changes in one or more of those matters must be such as to terminate the existence of the trust.

Ultimately, then, there are a few situations where a trust resettlement can arise:

1. Where a proposed amendment to the trust terms is not within the scope of the amending power (as discussed above);
2. Where the proposed amendment is within the scope of the amending power, but it fails to satisfy the three indica laid out in *Clark*. This typically encompasses changes that are fundamental in nature (giving rise to a change in future rights, obligations and entitlements to persons party to the trust) rather than merely administrative, and sufficiently severs the trust relationship between the trustee, the beneficiary and trust property;
3. Where the proposed amendment inadvertently exercises some other power under the trust deed and redeclares the trust, including through the use of unhelpful trust declaration wording in relation to existing trust assets; and
4. Where the trust vests and/or beneficiaries, who are absolutely entitled to trust property, exercise their power to bring the trust to an end pursuant to the principle in *Saunders v Vautier*[74].

From a practical standpoint, the issue of a potential trust resettlement most often arises in the context of altering the beneficiaries of a trust, either by addition or exclusion. This is demonstrated in the following private ruling, where the ATO considered that a trust resettlement did not occur:

> **Private Tax Ruling Identification Number 1052169206128 (2023)**
>
> The trust's specified beneficiaries are individuals A and B. The general beneficiaries are their children, C, D, E and F. The trust deed provided powers for the trustee to exclude beneficiaries, and to make changes to the Appointor of the trust. The trustee proposed to amend the trust deed as follows:
>
> - Remove some beneficiaries
> - Remove individual A as Appointor
> - Appoint individual C as Appointor
> - Add individual C as the specified beneficiary
> - Add individual A as a general beneficiary
>
> Individual A will also resign as Appointor.
>
> The ATO considered that CGT events E1 and E2 do not arise in relation to the proposed amendments. This is on the basis that the proposed amendments are considered within the powers of the Trustee as contained in the trust deed, and will not cause the Trust to terminate or give rise to a particular asset of the Trust being settled on terms of a different trust.

[74] [1841] 4 Beav 115.

# 11. Vesting of the trust

The vesting day of a trust refers to the specific date, or event, upon which interests in trust property become fixed. If vesting depends on an event, it would generally be a milestone, such as a principal beneficiary passing away, or a beneficiary reaching a particular age or graduating from university.

The vesting day is determined in the trust deed, which may refer this day as the 'vesting day or 'termination date'. For example, the trust deed may provide wording similar to the following:

> *"Vesting Day means the earlier of:*
>
> > *(a) 80 years from the date of settlement of the Trust;*
> >
> > *(b) subject to a written resolution of the Trustees to such effect, such date determined by the Trustees in writing if any Principal Beneficiaries are alive, then served upon the surviving Principal Beneficiaries notwithstanding whether such determination is revocable or irrevocable; or*
> >
> > *(c) subject to a written resolution of the Trustees to such effect, the date of death or earliest date of death of a Principal Beneficiary."*

Whilst all states and territories, with the exception of South Australia, have introduced legislation to limit the 'perpetuity period' to a maximum of 80 years from the date of settlement of the trust, it cannot be assumed that the trust will only vest at the maximum permissible period. The modern trust deed usually provides for vesting at 80 years. However, some older trusts provide vesting at 30 to 40 years.

## 11.1 What happens on vesting of the trust?

Commonly, the trust deed would specify that a trustee is to hold the trust fund for specified beneficiaries on vesting, such that those beneficiaries become absolutely entitled to the trust fund. Consider the following clause as an example:

> *"On the Vesting Day, the Trustees will stand possessed of the Trust Fund on trust for any or all of the Beneficiaries, and to the exclusion of the others or other of the Beneficiaries then living or in existence, and if more than one then in such shares and proportions and from such sources and in such manner generally as the Trustees in their absolute discretion may determine, at any time or times before the Vesting Day by revocable declaration whether oral or by any instrument or instruments in writing, but so that any revocable determination if not revoked before the Vesting Day will be irrevocable on that date, and in default of a determination or to the extent such determination does not extend to the whole of the Trust Fund:*
>
> > *(a) where the Vesting Day was determined as a result of the occurrence of the death of a Principal Beneficiary, for the estate of the deceased Principal Beneficiary whose death determined the Vesting Day; otherwise*
> >
> > *(b) for the surviving Principal Beneficiaries as tenants in common in equal shares; otherwise*
> >
> > *(c) for the lineal descendants of the Principal Beneficiaries and if more than one then as tenants in common in equal shares; otherwise*
> >
> > *(d) for the person or persons who in accordance with the laws of intestacy that exist under the laws of the Trust Fund would have been entitled to the estate of the first and second named Principal Beneficiaries if each had died intestate on the Vesting Day domiciled in the relevant state or jurisdiction of the law of the Trust Fund and if more than one as tenants-in-common in equal shares.*

Whilst the above clause provides that the trustee shall hold the trust fund for a group of default beneficiaries, it provides flexibility for the trustee to determine—before the vesting day—such other beneficiaries who would otherwise benefit. Therefore, a trustee who is aware of an impending vesting day may plan appropriate in preparation for the vesting day.

As a consequence of the trust becoming ‘fixed’ at the vesting day, the trustee will no longer have discretionary powers to allocate income and capital of trust. The trustee is generally obligated to collect all trust income and assets, pay all liabilities and expenses, and distribute the trust fund to the specified beneficiaries. If the trustee derives income thereafter, all such income would be attributed to the specified beneficiaries (i.e. there is no discretion to make distributions in a tax effective manner under Division 6 of the ITAA 1936.

The tax implications on vesting of a trust should be examined carefully. The Commissioner’s view, as set out in Taxation Ruling TR 2018/6, is that determining whether or not a CGT event happens on vesting requires a close consideration of the trust deed.

If the trust fund does not consist of any CGT assets or consists solely of pre-CGT assets, then there will generally be no CGT or other tax consequences on vesting. On the other hand, if the trust fund comprises of CGT assets and there is a requirement to dispose and/or transfer assets to beneficiaries, then one or more CGT events may arise.

This will include considering the effect of vesting on the beneficial interests in the trust, and the nature of the property held on trust.[75] For example, the vesting of a trust can give rise to CGT event E5: beneficiary becoming entitled to a trust asset. Under CGT event E5, a capital gain arises for the trustee if the market value of the asset (at the time of the event) is more that its cost base in the asset, and a beneficiary makes a capital gain if the market value of the asset (at the time of the event) is more than the cost base of the beneficiary’s interest in the trust capital to the extent it relates to the asset (which would generally be insubstantial).

The following private ruling illustrates how the ATO considers CGT event E5 may occur on vesting:

> **Private Tax Ruling Identification Number 1052105674731 (2023)**
>
> *Question to ATO:* Will the vesting of the Trust, either in two or three beneficiaries, result in these beneficiaries becoming absolutely entitled as against the Trustee to the CGT assets of the Trust so as to trigger Capital Gains Tax (CGT) event E5?
>
> *ATO response:* No.
>
> Clause X of the Trust Deed provides that the Trustee:
>
> > *...shall stand possessed of the Trust Fund on the Vesting Day in trust as to income and capital for such of the Beneficiaries as are then living, or any one or more of them exclusive of the other or others in such shares and proportions as the Trustee in his* absolute discretion may determine on or within a period of fourteen days before the Vesting Day...
>
> In accordance with clause X of the Trust Deed, on the Vesting Date the Trustee intends to vest the Trust Fund (Vesting Resolution) in two or three beneficiaries in equal proportions.
>
> Clause 5 of the Vesting Resolution will state:
>
> > *It is resolved that, in accordance with clause 4 of the Trust Deed, the Company will stand possessed of the income and capital of the Trust Fund of the Trust for the following beneficiaries in equal proportions:*

[75] See [15] in TR 2018/6.

The beneficiaries will be either two of the siblings or three of the siblings, as determined at the time of the Vesting Resolution. The reason for the trustee currently being uncertain as to whether the trust property will be held for two or three siblings is that there is uncertainty within the family as to who wants to own the assets after the Vesting Date. It may be that one of the siblings instead benefits from other family assets that are not held by the Trustee.

*ATO reasons:*

CGT event E5 happens if a beneficiary becomes absolutely entitled to a CGT asset of a trust (except a unit trust or a trust to which Division 128 applies) as against the trustee (subsection 104-75(1)).

The trustee makes a capital gain if the market value of the asset (at the time of the event) is more than its cost base or a capital loss if that market value is less than the asset's reduced cost base (subsection 104-75(3).

A capital gain or capital loss is disregarded if the assets were acquired before 20 September 1985 (subsection 104-75(4)).

Determining whether or not a CGT event happens on vesting requires a close consideration of the deed. This will include consideration of the effect of vesting on the beneficial interests in the trust, and the nature of the property held on trust.

TR 2004/D25 *Income tax: capital gains: meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust'* as used in *Parts 3-1 and 3-3 of the Income Tax Assessment Act 1997* (TR 2004/D25) explains the circumstances in which a beneficiary of a trust is considered to be absolutely entitled to a CGT asset of the trust as against its trustee:

> 10. The core principle underpinning the concept of absolute entitlement in the CGT provisions is the ability of a beneficiary, who has a vested and indefeasible interest in the entire trust asset, to call for the asset to be transferred to them or to be transferred at their direction...
>
> 23. If there is more than one beneficiary with interests in the trust asset, then it will usually not be possible for any one beneficiary to call for the asset to be transferred to them or to be transferred at their direction. This is because their entitlement is not to the entire asset.
>
> 24. There is, however, a particular circumstance where such a beneficiary can be considered absolutely entitled to a specific number of the trust assets for CGT purposes. This circumstance is where:
>
> - the assets are fungible;
> - the beneficiary is entitled against the trustee to have their interest in those assets satisfied by a distribution or allocation in their favour of a specific number of them; and
> - there is a very clear understanding on the part of all the relevant parties that the beneficiary is entitled, to the exclusion of the other beneficiaries, to that specific number of the trust's assets.
>
> 25. Because the assets are fungible, it does not matter that the beneficiaries cannot point to particular assets as belonging to them. It is sufficient in these circumstances that they can point to a specific number of assets as belonging to them.

Assets are fungible if each asset matches the same description such that one asset can be replaced with another. Assets are fungible if they are of the same type (for example, shares in the same company and with the same characteristics).

Fungible assets form a separate class for the purpose of determining the number and type of assets to which each beneficiary is regarded as being absolutely entitled.

Clause 4 of the Trust Deed provides that the Trustee:

> *...shall stand possessed of the Trust Fund on the Vesting Day in trust as to income and capital for such of the Beneficiaries as are then living, or any one or more of them exclusive of the other or others in such shares and proportions as the Trustee in his absolute discretion may determine on or within a period of fourteen days before the vesting day and in default of any such determination as aforesaid shall stand possessed of the Trust Fund for such of the children of the Principal as shall then be living, and if more than one as tenants in common in equal shares...*

In accordance with clause 4 of the Trust Deed, on the Vesting Date the Trustee intends to vest the Trust Fund in two or three individual beneficiaries.

The Trust Fund consists of three different types of assets:

- units in a unit trust
- company shares of the same class
- cash.

Each of the three types of assets are fungible assets within their own asset type, as they match the same description within their asset class such that one asset can be replaced with another.

Each asset type is conveniently divisible by two if they were left in two equal shares. The Units in the Unit Trust and the cash are divisible by three if left in equal shares to three beneficiaries, However the Company shares are not conveniently divisible by three.

The trustee does not intend to allocate particular assets to particular beneficiaries on vesting and will continue to hold the Trust Fund for the beneficiaries on vesting.

As there is more than one type of asset and more than one beneficiary, it is not clear how the assets will be allocated.

The determination that the beneficiaries on vesting are to 'share equally' does not make it clear whether or not specific assets or asset types are to be held for each of the siblings. Because the trustee has not recorded a specific number of assets as being held for each beneficiary, the beneficiaries will not be absolutely entitled to any of the Trust's assets on the Vesting Date.

Accordingly, CGT Event E5 will not happen when the Trust vests.

## 11.2 Extending the vesting day

Subject to a breach of the ‘rules against perpetuities’, the vesting day of a trust may be extended. There are potentially three ways to extend the vesting day:

- Exercising a power provided under the trust deed;
- Obtaining consent of all beneficiaries;[76] and

[76] This is reliant on the rule in *Saunders v Vautier* [1841] EngR 765, which provides that, if beneficiaries are of full age and they consent unanimously, they can direct the trustees to terminate the trust and distribute the assets, regardless of the terms of the trust deed. If there are minors or unborn beneficiaries, the rule cannot be applied as these parties cannot give

- Obtaining an order of the court.[77]

We examine extending the vesting day by way of an exercise of power under the trust deed.

A trust deed may facilitate extension of the vesting day by providing a specific power in the deed to deal with the matter, or provide a broad amendment power. In any event, the scope of any power must be wide enough to facilitate extension of the vesting day, and construction of the relevant provisions (including through the principles discussed in section 9 of this paper) should be examined. For example, a provision in the trust deed that specifically prohibits extension (or postponing) of the vesting day and which requires that all income and assets of the trust must be held for the takes-in-default on vesting would suggest that vesting is not permissible—notwithstanding a broad amendment power found elsewhere in the deed.

Care must also be undertaken in extending the vesting day, as it could result in a resettlement of the trust.

In *Andtrust v Andreatta*[78], where a broad amendment power was considered, it was confirmed that where a trust deed contains a power to vary the trust, it should be assumed that the relevant power includes the ability to extend the vesting period (subject to the perpetuity period rules). This rule only applies, however, where the vesting day is not intended to be of fundamental importance (that is, an essential feature of the trust).

The ATO's application of the principles on extension of a vesting day is demonstrated in the following private ruling, where the ATO considered that a trust resettlement would not occur from a proposed amendment of the trust deed to extend the vesting day:

> **Private Tax Ruling Identification Number 1051583205177 (2019)**
>
> Clause 28 of the Trust Deed provides the Trustee with a general power to vary the terms of the Trust.
>
> Subclause 1(12)(b) of the Trust Deed provides an express power to the Trustee to appoint a date later than 30 June XXXX as the "Vesting Day" subject to the consent of the Guardian on condition that such date is later than the date specified in the Schedule, and also being within the period of perpetuity.
>
> *Extending the Vesting Day*
>
>> The proposed amendment to the Vesting Day of the Trust will extend the date from 30 June XXXX to 17 May ZZZZ.
>>
>> The issue of extending a vesting date is considered in Example 3A of TD 2012/21. It states:
>>
>> 10A. The Wombat Family Trust is a discretionary trust settled on 31 March 1981 to benefit the members of the Wombat family. The eligible beneficiaries of the trust are defined as Mr William

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their consent. In *Re Dion Investments Pty Ltd* [2014] NSWCA 367, the Court of Appeal in NSW indicated, by reference to *Saunders v Vautier* that it may be possible to rely on that decision to extend the vesting day of the trust, although this may give rise to a trust resettlement: *"46. Where the trust instrument contains no such variation provision, principles of equity may countenance variation of the terms of the trust with the unanimous consent of the beneficiaries if all are in being, sui juris and absolutely entitled. Under the principle in Saunders v Vautier (1841) 4 Beav 115; 49 ER 282 (affd (1841) Cr & Ph 240; 41 ER 482), beneficiaries in that position are entitled to put an end to the trust and to require that the trust property be transferred to them. Their capacity to produce that result also enables them to require, as an alternative, that the property be held by the trustee upon varied trusts; but, if they do so require, the situation may in truth be one of resettlement upon new trusts rather than variation of the pre-existing trusts (and the trustee may not be compellable to accept and perform those new trusts: see CPT Custodian Pty Ltd v Commissioner of State Revenue [2005] HCA 53; 224 CLR 98 at [44])."*

[77] Reference is made to the recent decision of the Supreme Court of Victoria in *Re Gengoult-Smith Family Trust* [2024] VSC 189, which concerns an application by beneficiaries of the trust to the court to approve the extension of the vesting day under section 63A of the *Trustee Act 1958* (VIC). The court had adopted a two stage process in considering the application: first stage was to determine whether the proposed arrangement would be for the benefit of the minor and potential unborn beneficiaries of the trust, and second stage was to assess whether the proposed arrangement is proper and fair (which involves considering the arrangement as a whole, including the advantages to various stakeholders, their bargaining strength and the trust's purpose).

[78] [2015] NSWSC 38.

Wombat, his spouse Wanda, any of his children or grandchildren born before the trust's vesting date and any spouse of his or his children or grandchildren born before the vesting date. The deed contains a clause specifying the vesting date as 31 March 2021.

10B. The trust deed also contains a clause granting the trustee a power of variation that can be exercised prior to the vesting date, and which includes enlarging any category of eligible beneficiaries so far as the power shall not infringe the rule against perpetuities.

10C. The trustee wishes to extend the vesting date of the trust so as to enlarge the class of eligible beneficiaries that may benefit under the trust to include children, grandchildren or spouses of children or grandchildren born after the vesting date.

10D. The trustee resolves to extend the vesting date to 31 March 2051. Extending the vesting date to 31 March 2051 will not infringe the rule against perpetuities.

10E. The clause governing the trustee's powers to vary the trust deed contemplates that enlarging the category of eligible beneficiaries may involve extending the vesting date of the trust, given the specific limitation of the trustee's powers to not infringing the rule against perpetuities. The trustee's resolution is a valid exercise of the amendment power.

10F. The making of the resolution, being a valid exercise of a power of variation contained within the trust deed, does not give rise to the happening of a CGT event. The result would be the same if the vesting date was extended with the approval of a relevant court rather than under the trust deed.

Clause 28 of the Trust Deed provides the Trustee general powers to vary the Trust Deed. Subclause 1(12)(b) of the Trust Deed provides an express power to the Trustee to appoint a later Vesting Day, subject to the agreement of the Guardian and the date is within the perpetuity period. Both of these requirements will be met by the proposed new Vesting Day.

Stein v Sybmore Holdings Pty Ltd NSWSC 1004 notes that the effect of an extension to a vesting date will be to change the beneficial interests in the Trust Fund; however having regard to the particular circumstances of this case, the express power of amendment of the Vesting Date combined with the short extension to the Vesting Date to align with the perpetuity period, the potential change in beneficial interests is not of a fundamental nature and is consistent with changes in the membership of a continuing beneficiary class.

Overall, it is considered that the proposed change to the Vesting Date of the Trust is an extension of the term of the trust and is consistent with a continuing trust estate.

*Changes to definitions of Guardian and Appointor*

Currently the respective definitions of Guardian and Appointor refer to the Schedule to the Deed for the occupier of those positions and their specified next in line. The proposed changes to the definitions are to allow the existing Guardian and Appointor to nominate a substitute, either during their lifetime or by a will.

Paragraphs 24 and 27 of the Appendix 1 Explanation to TD 2012/21 states:

> *24. Even though Clark and Commercial Nominees were decided in the context of whether changes in a continuing trust were sufficient to treat that trust as a different taxpayer for the purpose of applying relevant losses, the ATO accepts the principles set out in these cases have broader application. Relevantly, the principles established by those cases are also relevant to the question of the circumstances in which CGT event E1 or E2 may happen as a result of changes being made to the terms of an existing trust*

> *pursuant to a valid exercise of a power in the deed (including a power to amend). In light of those principles, the ATO accepts that a change in the terms of the trust pursuant to exercise of an existing power (including an amendment to the deed of a trust), or court approved variation, will not result in a termination of the trust and, therefore, subject to the observation in paragraph 27 below, will not result in CGT event E1 happening.*
>
> *27. Even in instances where a pre-existing trust does not terminate, it may be the case that assets held originally as part of the trust property commence to be held under a separate charter of obligations as a result of a change to the terms of the trust - whether by exercise of a power under the deed (including a power to amend) or court approved variation - such as to lead to the conclusion that those assets are now held on terms of a distinct (that is, different) trust.*

The proposed changes to the definitions do not alter either the rights of beneficiaries or the assets of the Trust and the Commissioner, in the absence of any other factors, accepts they are changes of an administrative nature.

*Cumulative changes*

The combined effect of the proposed amendments namely the changes to the Vesting Date and the definitions of Guardian and Appointor are indicative of a continuing trust estate. Accordingly, the proposed amendments do not cause a change in the trust relationship such that one trust ceases and a new trust is created.

# Appendix A.1 – Annual trust distribution checklist[79]

<table>
<tr><th>Step</th><th>Matters to consider</th><th></th></tr>
<tr><td>1. Start with the trust deed</td><td>The necessary starting point is the trust deed, as it provides the specific requirements of the trust that must be followed for the trustee to validly make a distribution of income and/or capital to beneficiaries. On this basis, the trustee should:<br><br>(A) Locate the trust deed<br><br>Obtain a complete copy of the trust deed, including all amendments and all pages.<br><br>If the trust deed has been lost, then all attempts should be made to locate the trust deed (including an unsigned version or an earlier version). Avoid the temptation of signing a new deed, as this will cause a trust resettlement.<br><br>(B) Carefully read and understand the trust deed<br><br>Where multiple amendments have been made, consider consolidating the amendments into a single document. This facilitates the ease of following the trust deed and reduces the risk of error.<br><br>Where a trustee’s resolution does not meet the requirements of the trust, the resolution may not be effective. This may result in other beneficiaries or the trustee instead being assessed on the trust’s net income. Where the trustee is assessed, that is at the top marginal tax rate.</td><td>☐</td></tr>
<tr><td>2. Confirm that the trust has not vested</td><td>Check the trust deed to confirm that the trust has not yet vested. If it has, entitlements to income will already have vested in those beneficiaries entitled to the trust fund on the vesting day and any attempt by the trustee to appoint income or capital that is inconsistent with those entitlements will not be effective.<br><br>It cannot be assumed that the trust has not vested and that the trust has a maximum life span of 80 years or, subject to the trust having its proper law in South Australia, an infinite period. Some trust deeds provide for a shorter vesting day. If the trustee identifies an impending vesting day, it is possible to extend the vesting day before that day comes, noting that there can be tax and other consequences on vesting. For a further discussion, refer to section 11 of this paper.</td><td>☐</td></tr>
<tr><td>3. Determine what the trustee can distribute</td><td>(A) What is income?<br><br>It is important to determine what constitutes as income of the trust (i.e. accounting income or net income based on tax law principles). The trustee must understand how income of the trust is calculated.<br><br>For example, if the deed defines the income of the trust to be an amount equal to the trust's net income, the resolution should not seek to appoint accounting income. This can give rise to the risk that not all of the income has been distributed and leading to unexpected tax and trust outcomes.<br><br>Further, the trustee should have an idea of the amount of income derived during the year, even though the final accounts would not generally be ready at the time of distribution.</td><td>☐</td></tr>
</table>

[79] This checklist is based on the ATO’s annual trust distribution checklist: https://www.ato.gov.au/businesses-and-organisations/trusts/in-detail/trust-tax-time-toolkit/resolutions-checklist

| Step | | Matters to consider | |
|---|---|---|---|
| | | ***(B) Is streaming of capital gains or franked distributions permitted?***<br><br>If the trustee is seeking to 'stream' capital gains or franked distributions (i.e. seeking for their character to be retained as capital gains or franked distributions in the hands of beneficiaries), then the trustee must:<br><br>• ensure that the trust deed allows for streaming and the trustee is not prohibited from streaming; and<br><br>• ensure that it has complied with relevant legislative requirements relating to the creation and recording of these entitlements.<br><br>For example, if a trustee wants to stream a capital gain to a particular beneficiary so that the gain is assessed only on that beneficiary, the beneficiary must be entitled to all of the financial benefits referable to the capital gain. In a trust where income is defined by reference to net income, a resolution distributing that part of the income attributable to the discounted gain will only create an entitlement to 50% of the financial benefits that arise from the capital gain—that is, the discount component of the capital gain will not form part of the income of the trust, and this will need to be specifically dealt with in the resolution.<br><br>For completeness, other types of income cannot be separately streamed to different beneficiaries in the way that capital gains and franked distributions can be streamed. Each beneficiary is taxed on a proportionate share of each component of the trust's net income and cannot be treated as having a share of net income that consists of one category of income that is neither a capital gain or a franked distribution. | |
| **4.** | **Determine whom the trustee can distribute to** | Check the trust deed to ensure that the intended beneficiaries are within the class of persons who can benefit from a distribution of trust income or capital. Do not assume that a related company or related trust is an eligible beneficiary.<br><br>Confirm that the intended beneficiaries are not excluded beneficiaries. For example, some trust deeds specifically exclude the trustee of the trust from being a beneficiary or exclude 'foreign persons' as being beneficiaries.<br><br>If the trustee makes a distribution to someone who is not a beneficiary, the default beneficiaries (if any) or trustee may be assessed on a corresponding part of the trust's net income.<br><br>If a family trust election and interposed entity election have been made by the trust,[80] then ensure that the intended beneficiaries are within the family group of the individual specified in the election. Otherwise, the family trust distribution tax liability (at rate of 47%) will be imposed on the trustee. The beneficiaries who would otherwise be assessable because of the resolution will not be assessable.<br><br>Depending on the trust, there may be various types of beneficiaries (primary, general, income, capital and default), the rights of each of which depend on the terms of the Trust Deed. For example, an 'income' beneficiary may be entitled to income of the trust only and not capital of the trust.<br><br>If a nomination of the beneficiary is required, then understand how this process must take place and when this needs to be undertaken. | ☐ |

[80] The benefits of making a family trust election are broadly to: (i) simplify the use of carry forward tax losses; (ii) simplify loss tracing for companies; (iii) facilitate access to franking credits; (iv) compliance with trustee beneficiary reporting rules; and (v) facilitate access to the small businesses restructure CGT rollovers.

<table>
<tr><th>Step</th><th>Matters to consider</th><th></th></tr>
<tr><td>5. Ensure 'real and genuine' consideration of beneficiaries</td><td>Recall that trustees have a fiduciary duty to consider the beneficiaries of the trust in distributing income or capital, even when their discretion is couched in absolute terms according to the trust deed. Accordingly, ensure that the trustee is not prematurely excluding any beneficiaries. Refer to the discussions on the Owies decision in section 4 of this paper.</td><td>☐</td></tr>
<tr><td>6. Deal with Section 100A</td><td>In light of the ATO’s position and recent publications on section 100A of the ITAA 1936—see Taxation Ruling TR 2022/4 and Practical Compliance Guideline PCG 2022/2, which provides a traffic light system and sets out circumstances where the ATO may dedicate compliance resources in scrutinising trust distributions—it is prudent that a trustee considers the potential application of section 100A as part of its annual trust distribution process.<br><br>(A) What is section 100A?<br><br>Section 100A is an anti-avoidance rule that can apply where a beneficiary’s trust entitlement arose from a reimbursement agreement. A reimbursement agreement involves an arrangement under which a beneficiary is made presently entitled to trust income and:<br><br>• someone other than that beneficiary receives a benefit in connection with the arrangement; and<br><br>• at least one of the parties enters into the agreement for a purpose of reducing tax.<br><br>If section 100A applies, the beneficiary’s entitlement for tax purposes is disregarded. The net income that would otherwise have been assessed to the beneficiary (or trustee on their behalf) is instead assessed to the trustee at the top marginal tax rate.<br><br>(B) Observations on section 100A<br><br>It is beyond the scope of this paper to examine section 100A in detail. Much has been written on section 100A in recent years. For present purposes, the following observations are made about section 100A:<br><br>a) Section 100A does not apply in the following circumstances:<br><br>• the arrangement simply involves a beneficiary receiving and using their trust entitlement—i.e. if $100 is distributed to Bill and Bill uses all of it for his own personal expenses, then section 100A does not apply. If, however, Bill has an arrangement to pass on some of the benefits to other people who are on a higher marginal tax rate, then section 100A may potentially apply;<br><br>• the agreement has been entered into in the course of ‘ordinary family or commercial dealing’. This is ultimately a question of fact. The test is an objective one, looking into the perspective of relevant people and not necessarily limited to the beneficiary and the trustee. The starting position is to determine if the dealing is capable of explanation by sensible family and/or commercial objects rather than being explainable by reference to payment of less tax to maximise group wealth only. This can also call into question matters such as:<br><br>o the historical behaviour of the parties (i.e. is the arrangement something that is ‘regular’ or normal for the parties); and<br>o whether the dealing is artificial or contrived; overly complex; contain steps that are not needed to achieve the family or</td><td>☐</td></tr>
</table>

| Step | Matters to consider | |
|---|---|---|
| | commercial objectives; or contain steps that might be explained instead by objectives different to those said to be achieved; and<br>• the presently entitled beneficiary is under 18 years of age or is otherwise under a legal disability.<br>b) In PCG 2022/2, the ATO indicates that an arrangement is low-risk (i.e. green zone), where the beneficiary receives their entitlement within 2 years of becoming presently entitled and uses the entitlement;<br>c) The ATO requires sufficient records to explain the transactions that have happened in demonstrating that section 100A does not apply. The records relevant to an arrangement will differ depending on the circumstances. However, as a general guide, the following documents and records should be kept where possible:<br>• trust deed (including amendments), trustee resolutions, your contact details and details of the former trustee(s) if any;<br>• notes, records of discussions or meetings explaining the transactions that have happened or calculations made;<br>• details of how:<br>o the beneficiary was notified of their present entitlement to trust income;<br>o the trust income was received or used by the beneficiary;<br>o you utilised the beneficiary's present entitlement if they were not paid;<br>• loan agreements and records showing how loan repayments were satisfied; and<br>• file notes of a meeting between the trustee and its tax agent. | |
| **7. Be mindful of Part IVA** | Even where section 100A does not apply, the ATO can invoke the general tax anti-avoidance provisions in Part IVA of the ITAA 1936 in scrutinising a trust distribution.<br>For example, consider Taxpayer Alert TA 2022/1, which describes trust arrangements where parents enjoy the economic benefit of trust income appointed to their children who are over 18 years of age (the children). The common feature of these arrangements, as described by the ATO, is that trust income is appointed between members of the family group but in substance it is the parents who exercise control over and enjoy the economic benefit of the income.<br>In some arrangements, there is an understanding that trust income appointed to the children will be paid to their parents or otherwise dealt with at their parents' discretion. In others, the trust income appointed to the children is recorded as applied (with or without their knowledge) to repay amounts owed by them to their parents, being amounts owed in respect of expenses that benefit the children but are properly understood as parental expenses. Examples of these expenses are the costs of their upbringing as a minor or for the kinds of ongoing financial support parents would ordinarily provide their children.<br>The ATO indicates that in reviewing such arrangements, it would consider how the following may apply: | ☐ |

| Step | | Matters to consider | |
|---|---|---|---|
| | | • whether the children's entitlement to trust income may be a sham or otherwise ineffective for trust law purposes;<br>• whether the arrangement constitute as a reimbursement agreement under section 100A;<br>• whether sections 95A(1) and 97(1) of the *Income Tax Assessment Act 1936* (Cth) may apply to treat the [arents as presently entitled where the means by which the trustee permits the use of the funds evidences the exercise of a discretion to pay or apply those amounts to the parents (notwithstanding that the appointments are recorded as 'beneficiary loans'), and<br>• whether Part IVA could apply. | |
| **8.** | **Making and documenting the resolution** | When the time comes for the trustee to make the distribution, the starting position is again to consult the trust deed on any particular requirements that need to be followed. These can include the following:<br><br>***(A) Timing***<br><br>For tax purposes, in order to make beneficiaries 'presently entitled' to trust income for an income year and being subject to income tax on their distribution, a resolution will only be effective if it is made by the end of the income year (30 June).<br><br>If the trustee is making beneficiaries specifically entitled to trust capital gains by way of appointing trust capital to them, that must be done within 2 months of the end of the income year (31 August).<br><br>However, sometimes a trust deed will require a resolution to be made before the end of the income year. In this case the trustee must comply with the deed. For example, if the trust deed requires the resolution to be made by 28 June, then the resolution must be made by that date.<br><br>***(B) Present entitlement***<br><br>For a beneficiary to be presently entitled to trust income, their right to the income must be indefeasible. That is, the entitlement must not be capable of being taken away. If an entitlement to trust income can be taken away from a beneficiary, then the trustee may be assessed on the corresponding part of the trust's net income. For example, a resolution would not be effective to create a vested entitlement to income if it stated that an entitlement of a beneficiary would arise in the event of a future adjustment to the trust's net income by the ATO.<br><br>A beneficiary's entitlement must be vested by 30 June. An entitlement that arises on the happening of an event in the future, is not vested.<br><br>***(C) Form of the resolution***<br><br>Given that there are a wide variety of trust deeds with potentially different requirements for trustee resolutions, a trustee should not simply follow a standard form resolution.<br><br>The important thing is that the resolution, to be effective, must makes one or more beneficiaries presently entitled to the trust income by 30 June and must follow any requirements of the trust deed to make this happen.<br><br>Further, the resolution should be clear and unambiguous, and robust enough to deal with any contingency.<br><br>***(D) Does a resolution have to be in writing?*** | ☐ |

| Step | Matters to consider |
|---|---|
| | Whether the resolution must be recorded in writing will depend on the trust deed. Some trust deeds permit a resolution to be made orally by the trustee, but it must then be later recorded in writing.<br><br>A written record will, however, provide better evidence of the resolution and avoid a later dispute, for example with the ATO or with relevant beneficiaries, on whether any resolution was made.<br><br>Further, a written record will be essential if the trustee wants to effectively stream capital gains or franked distributions. This is because a beneficiary can only be specifically entitled to franked dividends or capital gains if this entitlement is recorded in writing in the records of the trust either:<br><br>• by 30 June for franked dividends<br><br>• by 31 August for capital gains.<br><br>For completeness, note the ATO will accept records after 30 June as evidence of the making of a resolution by that date, provided the requirements of the deed are met. Consider the following examples:<br><br>*Individual trustee:* On 29 June, an individual trustee writes a note, dated 29 June, stating that they have resolved to distribute the trust income in a certain way. On 15 July, the trustee types the note reflecting the resolution of 29 June and provides a copy to the beneficiaries. The ATO indicates that they will accept the handwritten or typed notes as evidence of the making of the resolution on 29 June.<br><br>*Corporate trustee:* The corporate trustees of a larger trust group map out where distributions are to be made, with appropriate percentages. This 'map' is signed by the relevant trustees on 26 June to evidence the resolutions that have been made. On 25 July, the resolutions are recorded in the minutes book maintained by the trustees. The ATO indicates that they will accept the signed 'map' or minutes book as evidence of the making of the resolutions on 26 June.<br><br>***(E) Are trust accounts required to be prepared by 30 June to make beneficiaries presently entitled to trust income?***<br><br>No, as the resolution does not need to specify an actual dollar amount for it to be effective in making a beneficiary presently entitled, unless the trust deed specifically requires it.<br><br>A resolution is effective if it prescribes a clear methodology for calculating the entitlement—for example, the entitlement can be expressed as a specified percentage of the income. Alternatively, if the trustee knows that the income of the trust will be at least a certain amount, it may choose to make one or more beneficiaries presently entitled to that certain amount, and other beneficiaries entitled to the balance, whatever that turns out to be.<br><br>***(F) What happens if you make a resolution after 30 June?***<br><br>If no beneficiary (including a default beneficiary) was presently entitled to trust income as at 30 June, and no beneficiary was made specifically entitled to trust capital gains (if any), then the trustee will be assessed on the trust's net income. |

# Appendix A.2 – Current trust activities in the ATO's radar

The following is a list of trust issues published by the ATO as attracting their attention.[81] This list is as of 8 August 2023:

| Matter | What is it? |
|---|---|
| **1. Circular trust distributions** | A circular trust distribution exists where a trust (the first trust) makes a distribution to a second trust. Then all or part of that distribution goes back to the first trust as a distribution from either the second or another trust.<br><br>We want to ensure that the trustees have complied with their obligations to trustee beneficiary non-disclosure tax. This includes trustees of family trusts for income years starting on or after 1 July 2019.<br><br>We focus on those circular trust distributions if tax has not been paid on some or all of the distribution because:<br>• one or more beneficiaries understate the trust amounts included in the beneficiary's assessable income<br>• there is an unbroken circular trust distribution between 2 or more trusts. |
| **2. Differences between distributable and net income** | We focus on tax-preferred beneficiaries, including private companies, where their distributable income is significantly less than the net income.<br><br>Whether or not this behaviour is considered tax avoidance depends on the case.<br><br>Situations that attract our attention include where:<br>• a trust has<br>  ○ a small amount of distributable income and a large amount of net income<br>  ○ supposedly made a tax-preferred beneficiary entitled to that distributable income<br>  ○ a difference between distributable income and net income which was either retained in the trust or extracted from the trust in a tax-concessional form<br>• steps have been taken to create or increase the difference between distributable and net income, or to include the tax-preferred entity as a beneficiary<br>• the trust deed has not been followed when calculating distributable income or assigning distributable income to beneficiaries<br>• the income of the trust includes franked dividends from a private company. |
| **3. Distributions of franked dividends** | We are concerned that beneficiaries and their advisors are not applying the franking credit integrity rules when making or receiving franked distributions. As a result: |

[81] https://www.ato.gov.au/businesses-and-organisations/trusts/in-detail/compliance/tax-avoidance-taskforce-trusts/trust-activities-that-attract-our-attention

<table>
<tr><th>Matter</th><th>What is it?</th></tr>
<tr><td></td><td><ul><li>individual beneficiaries are claiming franking credits when the qualified person rule or small shareholder exemption ($5,000) is not met</li><li>beneficiaries are claiming the franking credit tax offset from franked distributions (for shares acquired post 31 December 1997) received from discretionary trusts when the trust has not made a family trust election (FTE)</li><li>corporate beneficiaries are claiming or converting excess franking credits into losses when the holding period rule is not met.</li></ul></td></tr>
<tr><td>4. Distributions to complying superannuation funds</td><td>We focus on distributions from trusts to complying superannuation funds, including self-managed super funds (SMSFs). Any non-arm’s length income should be taxed in the superannuation fund at the top marginal tax rate.<br><br>We look for complying superannuation funds (generally SMSFs) that receive income distributions from a trust, where the distributions result from:<ul><li>the exercise of a discretion of the trustee</li><li>a fixed entitlement with one or more of the following features<ul><li>the fixed entitlement was not acquired on arm's length terms</li><li>the fixed entitlement was acquired using a loan from a related lender who is not on arm's length terms</li><li>the acquisition of assets within the trust was facilitated by loans between related parties which are not on arm's length terms</li><li>the rate of return received from the investments of the superannuation fund is not consistent with an arm's length return.</li></ul></li></ul></td></tr>
<tr><td>5. Distributions to tax-preferred beneficiaries</td><td>We focus on distributions to tax-preferred beneficiaries that may have been used by trustees to attempt to reduce the amount of tax paid on the trust's net income (as calculated under section 95 of the ITAA 1936).<br><br>Tax-preferred beneficiaries include:<ul><li>tax-exempt entities</li><li>entities that deduct excess deductions and tax losses against their share of the trust's net income</li><li>entities that apply capital losses or carried forward net capital losses against their share of the trust's capital gains</li><li>entities that pay lower or nil rates of tax</li><li>entities that lack the financial means to pay tax</li><li>non-resident beneficiaries that are either entitled to trust amounts that are subject to withholding tax or whose share of trust income is attributed to sources outside Australia.</li></ul>Situations that attract our attention include where:<ul><li>a tax-preferred beneficiary becomes entitled to an amount that is favourably taxed because of their characteristics</li><li>the entitlement of the tax-preferred beneficiary is not paid to them or is applied to someone else</li></ul></td></tr>
</table>

| Matter | What is it? |
|---|---|
| | • the tax-preferred beneficiary has been recently introduced into the trust, or has a weak social or economic connection with the persons controlling the trust<br>• steps were taken to change the character of the trust income so that the income of the tax-preferred beneficiary is favourably taxed<br>• the tax-preferred beneficiary is not able to pay the tax due on the trust entitlement<br>• the tax-preferred beneficiary is tax-exempt, whether or not the requirements in sections 100AA and 100AB of the ITAA 1936 have been met. |
| **6. Family trust distributions tax** | We focus on:<br>• a trust that has a family trust election in place (family trust) which is distributing outside the family group of the specified individual<br>• distributions to entities outside the family group by a trust, partnership or company which has made an interposed entity election (IEE) to be included in the family group of the specified individual of a family trust<br>• instances where an individual beneficiary incorrectly returned an amount on which family trust distributions tax (FTDT) has been paid. |
| **7. Income recharacterisation arrangements** | We focus on trusts where revenue activities are mischaracterised or transactions are undertaken for the dominant purpose of changing the character of trust income to:<br>• achieve lower rates of tax<br>• obtain access to benefits or concessions not ordinarily available to trusts.<br>Situations that attract our attention include:<br>• using special purpose trusts to recharacterise ordinary income as discountable capital gains<br>• changing the character of trust income to access the withholding tax provisions. |
| **8. Loss trust moved into group** | Trusts with significant revenue or capital losses that have recently been moved into a group attract our attention.<br>We focus on the carrying forward and use of revenue losses by a trust, to ensure the trust loss measures restrictions are applied.<br>In these situations, entities within the new group may attempt to take advantage by distributing capital gains to the capital loss trust. |
| **9. Non-lodgment** | If a trust has derived income, they will have to lodge a return, irrespective of the amount of income, unless exempted by the Commissioner.<br>Prompt lodgment of trust returns is integral to the integrity of the tax system. We rely upon the details provided in trust and beneficiary tax returns to satisfy ourselves that the appropriate amount of tax has been paid through the undertaking of tax assurance activities. |

| Matter | What is it? |
|---|---|
| | We focus on non-lodgment of trust and beneficiary tax returns. We use information matching techniques to identify returns that are overdue or where there is a potential mismatch. |
| **10. Non-residents' capital gains** | We focus on the capital gains of trusts that are attributed to a foreign resident beneficiary's interest in the trust that have not been assessed to the trustee under section 98 of the ITAA 1936.<br><br>Situations that attract our attention include trustees and foreign resident beneficiaries who rely on:<br>• section 855-10 to disregard capital gains made by a resident trustee<br>• section 855-40 where the trust is not a fixed trust<br>• source rules in taking the position that capital gains made by a trustee outside of Australia are not assessed to the trustee under section 98.<br><br>We focus on these situations because there is a higher risk that tax was avoided. |
| **11. Potential reimbursement agreements** | We focus on arrangements that may constitute a reimbursement agreement. These agreements involve a trustee making distributions to lower taxed beneficiaries while the economic benefits are directed to another entity. The other entity is often a controller of a privately owned group, close relatives of the controller or an entity within such a group.<br><br>We are concerned with these arrangements as they typically exhibit the following features:<br>• elements of contrivance<br>• undue complexity<br>• other features that do not show a commercial or family-based reason<br>• a motivation to shelter income from higher rates of tax.<br><br>Practical Compliance Guideline PCG 2022/2 *Section 100A reimbursement agreements - ATO compliance approach* describes the arrangements that are high risk and to which we will prioritise the allocation of our compliance resources.<br><br>An example of an arrangement that is high risk is outlined to Taxpayer Alert TA 2022/1 *Parents benefitting from the trust entitlements of their children over 18 years of age.* |
| **12. Unitisation arrangements** | We focus on arrangements involving private companies acquiring units in a unit trust. These arrangements may involve either the:<br>• company making a payment to the unit trust for the units<br>• unit trust issuing the units to satisfy a UPE, debt or other obligation owed to the company.<br><br>We are concerned if the cost of the units is more than what would have been paid had the parties been dealing at arm's length.<br><br>The funds representing the UPE are then either:<br>• retained in the unit trust as working capital<br>• used to make loans or payments to shareholders or associates of shareholders of the private company. |

<table>
<tr><th>Matter</th><th>What is it?</th></tr>
<tr><td></td><td>These arrangements may involve the application of Division 7A, section 100A or Part IVA of the ITAA 1936.</td></tr>
<tr><td>13. Value extraction and corpus distributions</td><td>Capital distributions, or entitlement to corpus, may involve extracting value from a trust in a non-assessable form (subject to the CGT events, section 99B and the specific entitlement rules in Subdivision 115-C of the ITAA1997).<br><br>Situations that attract our attention include when the:<ul><li>corpus entitlement is satisfied by<ul><li>an unrealised capital gain</li><li>using an unpaid income entitlement of a tax-preferred beneficiary</li><li>accessing value in another entity, such as a company or a superannuation entity</li></ul></li><li>capital distribution is funded from, or causes, a difference between the trust's distributable and net income</li><li>transfer of assets occurs to another trustee who intends both<ul><li>to hold them as a separate trustee on the same trust under a trust splitting arrangement</li><li>that the transfer should not trigger CGT events E1 and E2</li></ul></li><li>trustee has borrowed money to satisfy the corpus entitlement and is claiming deductions for the loan interest.</li></ul></td></tr>
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