

June 2010

Below is a recent article written by Allan Swan for CCH on amending the definition of income in family trust deeds following the release on 2 June 2010 of the Australian Taxation Office's decision impact statement in respect of the High Court's decision in *FCT v Bamford*. This article focuses on the process of amending those family trust deeds that do not have the income tax definition of trust income as the definition in the trust deed or an existing process in the deed for switching definitions.

At the end of this article you will also find links to a summary of the decision, alternate sample resolution that the trustee of a family trust might like to utilise in respect of resolving to switch definitions and a document fact finder. If you would like Moores Legal to review family trust deeds and prepare deeds of amendment (the usual cost for which would be \$495), please forward a completed document fact finder to Edward Skilton at 9 Prospect St, Box Hill eskilton@mooreslegal.com.au. Edward can be contacted on 03 9843 2186.

Amending the Definition of Income in Family Trust Deeds

With the release on 2 June 2010 of the Australian Taxation Office's (ATO's) *Decision Impact Statement* in respect of following the 2010 High Court decision in *FCT v Bamford* [2010] HCA 10, the trustees of the many Australian family trusts have a key administrative decision to make by the end of the same month. That decision is whether to amend the terms of trust to define the process of determining trust income for each financial year. At the same time secondary amendments to the trust Deed may also be made, eg expressly authorising a trustee to hold allocations of income on subtrust or separate trust and to set out the trustee's powers to stream different types of trust income and capital (see appendices B to F).

The implications of the decision in *Bamford* vary, depending both on the type of trust (trusts such as Government approved special disability trusts are always established using the trust law definition of income) and the means of establishment (deceased estates and testamentary trusts are taxed differently from trust established by deed or declaration). This article focuses on those implications for fully discretionary family trusts established by deed, particularly those whose deeds do not allow the trustee to determine trust income by reference to s 95(1) of *ITAA 1936*.

1. Proportional taxing v quantum taxing

The unanimous decision of the High Court in *Bamford* (see Appendix A) has gone part of the way in clarifying the law in relation to the taxation treatment of trust income. It is now clear that the terms of the trust deed governing trust document, eg a deed, Will or statute, are crucial in determining how trust income is to be taxed.

If the terms of trust define income in accordance with trust law or accounting principles (or the trust document is silent), the trust income for income tax purposes is allocated to beneficiaries (or accumulated as an addition to trust capital) in the same proportions as the income determined by trust law or accounting principles has been allocated or accumulated. This means that net capital gains can be allocated to beneficiaries who receive none of the trust law or accounting income and the tax on the net capital gains is

borne by the beneficiaries in receipt of the trust law or accounting income. This can be quite unfair if beneficiaries receiving a distribution of trust income have to bear the tax on net capital gains allocated for the benefit of other beneficiaries. By contrast, in some circumstances, an advantageous result can occur, eg where tax exempt beneficiaries such as Australian charities receive all trust income and the (nil) tax assessment of net capital gains allocated for the benefit of non-charitable beneficiaries falls their way.

If the terms of trust define income in accordance with s 95(1) of *ITAA 1936*, a quantum distribution of trust income can be made with each beneficiary's assessable income from the trust being exactly the amount of the distribution of income from the trust.

In 1992 the ATO confirmed its view that it was possible for a trustee to stream different categories of trust income and capital to different discretionary beneficiaries. Most commonly the categories of

income streamed by a trustee are net capital gains (eg to a beneficiary with a carry forward capital loss) and franked dividends (together with their franking credits). Where distributions are made by a trustee to beneficiaries that will have no taxable income, eg many minor beneficiaries and tax exempt beneficiaries such as religious and other charitable organisations, the trustee will frequently allocate categories of income other than franked dividends to those beneficiaries, removing the need for the beneficiaries to seek a refund of franking credits.

In the *Decision Impact Statement*, the ATO foreshadowed the withdrawal of *Taxation Ruling TR 92/3*. While it is clear that streaming of income can continue if trust income is defined in accordance with s 95(1) of *ITAA 1936*, the decision in *Bamford* made it clear that streaming is not possible for net capital gains and the status of streaming of other forms of income is unresolved by either the High Court or the ATO.

2. Mandatory v default definitions

The specific rules for the taxation of trusts are no certainty to remain constant in the future, even after the *Bamford* decision. It may be that the present advantages of using the s 95(1) definition of trust income may only continue for a matter of a few months or years and either the trust law or another definition of trust income may become the better choice of definition for many trusts. It may also be the case that different definitions may be preferable in different financial years.

Therefore it would prudent for a trustee of a fully discretionary trust to ensure that the definition of trust income in the trust deed, ie the tax definition, is a default definition of income and can be changed for future financial years as the need arises.

3. Risk of resettlement

The risk of a resettlement occurring and triggering a taxable CGT event or a dutiable transaction is a factor that needs to be considered whenever an amendment to the terms of a trust is contemplated. For CGT purposes the risk is an issue in respect of assets that have appreciated in value since their acquisition by the trustee. For state and territory duty purposes the risk is principally in respect of real estate and (outside Victoria) businesses.

A resettlement occurs whenever a fundamental change occurs in respect of the trust. Expanding the class of actual or potential beneficiaries has tended to be viewed by revenue authorities as a resettlement, whereas granting the trustee an additional mere administrative power has not. In the *Decision Impact Statement*, the ATO confirmed that its view of what constitutes a resettlement will still be determined with the statement of principles it released in 1999 and updated in 2001. In the revised statement, the ATO gave a number of examples of where a resettlement might occur, ie:

- “any change in beneficial interests in trust property
- a new class of beneficial interest (whether introduced or altered)
- a possible redefinition of the beneficiary class
- changes in the terms of the trust or the rights or obligations of the trustee
- changes in the nature or features of trust property
- additions of property which could amount to a new and separate settlement
- depletion of the trust property
- a change in the termination date of the trust
- a change to the trust that is not contemplated by the terms of the original trust
- a change in the essential nature and purpose of the trust
- a merger of 2 or more trusts or a splitting of a trust into 2 or more trusts”.

These examples are not prescriptive, eg in practice the ATO (as well as the state revenue offices) have not tended to view the exclusion of a means tested pensioner from the class of beneficiaries the pensioner does not control as a resettlement. In its *Decision Impact Statement*, however, the ATO has avoided setting out its views as to the circumstances where a change of definition of trust income would trigger a resettlement of a trust. Where, however, the amendment of the definition of trust income does not mean a change to the class of actual or potential beneficiaries, the risk of resettlement would appear to be low and the ATO (or a State Revenue Office) is likely to find it very difficult to persuade a tribunal or Court that a resettlement has occurred.

It would appear that there would be a much greater risk of resettlement (and thus a potential CGT event or dutiable transaction) if an amendment to the terms of trust resulted in a change to the class of actual or potential beneficiaries, eg because the:

- class of income beneficiaries in the terms of trust was different to the class of capital beneficiaries (rare in 21st century family trust deeds, but more common place in older trust deeds)
- default beneficiaries for income are different to the default beneficiaries.

(For many family trusts, the default distribution in terms of income is the accumulation of the unallocated trust income as an addition to the trust capital. By contrast the default distribution on a winding up of the trust is to specified beneficiaries such as the primary beneficiary or beneficiaries, the children of primary of beneficiaries or charities.)

In view of the risk of amending the default provisions, most deeds of amendment that effect a change to the definition of trust income expressly avoid any amendment of the default provisions.

4. Risk of triggering a Part IVA assessment

The 2nd risk that a person advising a trustee of a family trust might want to consider before amending the definition of trust income is the risk of triggering a Part IVA assessment. This is unlikely to be an issue where all or most of an accountant's clients with family trusts are amending their trust deeds following the Bamford decision, but could be an issue in the future when a one-off amendment coincides with a significant immediate tax advantage for a client or a group of clients.

5. Living with an accounting definition

For some family trusts, the choice of amending the trust deed to change the definition of trust income may not occur, eg because the risk of resettlement is perceived to be too great or there is no need for the amendment to occur. Examples of trusts whose income is defined by reference to trust law or accounting principles but that probably don't warrant an amendment to their terms of trust are trusts whose only purposes are limited to one or more of the following:

- to hold one or more non-income generating lifestyle asset
- to make secured or unsecured interest free loans (eg to enable a beneficiary to contribute to superannuation and at the same time reduce the beneficiary's net personal estate)
- to derive interest income (and thus have income that is identical for trust and tax purposes)
- to invest in a tax paid insurance bond (usually funded by the sale of a means tested pensioner's family home)
- to limit income distributions (from a trust not anticipated to derive income losses) to a single beneficiary going forward.

Where the trust is not amended because the risk of resettlement is too great, eg because there are differing actual or potential income beneficiaries and capital beneficiaries, the trustee has to administer the trust with 2 definitions of income in mind (at least until the Government decides to change the law relating to the taxation of trust income). It is advisable that the trustee consider carefully the practical and taxation consequences of any differences in trust income under the 2 definitions, eg as a consequence of:

- net capital gains
- franked credits accompanying fully or partly franked dividends
- building allowances
- primary production allowances
- entertainment expenses
- provision for staff leave
- prepayment of expenses or interest.

An example of the practical difficulties for the trustee occurs when a trustee wants to ensure that as a result of a trust distribution a beneficiary does not move to higher marginal tax rate or (in the case of a minor beneficiary who is not an excepted person under s 102AC of *ITAA 1936*) to the maximum marginal tax rate.

6. Next Steps – amending Trust Deeds and Training

June 2010 is likely to be a month where many trustees of family trusts resolve to amend their trust deeds to switch the definition of income from a mandatory trust law or accounting principles definition to hopefully a default definition of trust income defined by reference to s 95(1) of *ITAA 1936*. For practical reasons the consequential amendments to the governing trust deed to

Notes

1. If Moores Legal is to review the deed and prepare the deed of amendment please forward the relevant documentation to Edward Skilton. Edward is contactable to answer queries and can provide cost and time estimates. Contact details are: phone - (03) 9843 2186 or email – eskilton@mooreslegal.com.au.
2. Via **APT STEP** (Allan Swan's training business); training in relation to these recent developments can be scheduled via Lilian Bruère. Lilian is Allan Swan's personal assistant and Lilian's contact detail are: phone - (03) 9843 2153 or email lbruere@mooreslegal.com.au.
APT STEP training topics include: Asset Protection Planning; Blended Families; Business Structures Overview; Estate Planning – Key Cases and Rulings; Estate Planning – Practical Case Studies for 2010; Estate Planning – Tax and Strategic Issues; Funding Estate Planning; Ruling From the Grave; SMSFs – Planning Issues; Superannuation Death Benefits; Superannuation Overview; Testamentary Trusts; Trusts – Income and Capital Distributions; Trusts – The A-Z.
3. This article (together with its appendices), prepared in June 2010, is for training, educational and general information purposes only and should not be relied on as (or in substitution for) legal, accounting, financial or other professional advice. Note: All **APT STEP** materials are copyright and are only sold or otherwise made available on condition that the copyright will be respected.

Parts of this article (or a later version) will be included in the Family and Personal Trusts Chapter of the 1st edition of the forthcoming CCH Australian Master Estate Planning and Succession Guide. The author of the update, Allan Swan is a principal both of the Victorian law firm **MOORESLEGAL** and of the training services provider **APT STEP**.

List of appendices:

[Appendix A: CCH6A](#)

[Appendix B: Sample Consent to Amend Deed](#)

[Appendix C: Sample Resolution to Amend Deed \(multiple individual trustee\)](#)

[Appendix D: Sample Resolution to Amend Deed \(sole individual trustee\)](#)

[Appendix E: Sample Resolution to Amend Deed \(multiple directors\)](#)

[Appendix F: Sample Resolution to Amend Deed \(sole director\)](#)

[Appendix G: Family Trust Income Tax Definition Amendment Document Fact Finder](#)

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See the website for cross-references.

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