Trust Distributions Guide

Making effective trust distributions
Trust distributions guide

‘Trust law income’ and taxable ‘net income’ are not the same thing.

What is trust law income?
Trust law income is income according to trust law. This has been interpreted by numerous cases over time – principally aimed at the distinction between income (that would go to a spouse) and capital (that would go to children after a period of time). Trust law income has also imported notions of ‘accounting income’ or income according to ordinary concepts.

For trust law purposes the trust deed can override these common law principles to dictate what is and what is not included in trust law income for a particular trust. Some trust deeds define in strict terms what is and is not to be included, while others allow the trustee the discretion to determine what is meant by the term ‘trust law income’ (from year to year).

Trust law income is referred to by many different names, depending on the trust deed. It may be ‘trust income’, ‘income of the trust’, ‘income’, ‘accounting income’, ‘net income’, ‘annual income’, etc. All these terms used in trust deeds are referring to the same thing – trust law income.

The Tax Act 36 refers to “...the income of the trust estate” in section 97(1). The High Court in Bamford clarified that the phrase “income of the trust estate” in section 97(1) means trust law income.

What is assessable ‘net income’?
On the other hand, ‘taxable income’, ‘assessable income’ and ‘net income’ (as in section 95(1) Tax Act 36) are each defined in the Tax Act itself. These terms are purely creations of tax legislation. They only exist for the purposes of assessing tax. It is not possible for the trust deed to override tax law to change the nature of taxable income.

What can a trust distribute?
A trust can only distribute trust law income. That is it. No exceptions.

A trust cannot distribute ‘taxable income’ or ‘assessable income’ or ‘net income’. Neither trust law nor a trust deed can provide for the distribution of taxable income or assessable income.

Trust deeds that make trust law income equal assessable net income
Where people get confused is when the trust deed declares that trust law income is to be determined on the same basis as assessable ‘net income’, or where the trustee exercises its discretion to make trust law income equal assessable net income.

* e.g. Trust law income = ‘net income’ under section 95(1)*

What is happening here is that the trust deed is importing the concept of assessable net income into the trust deed. But this does not mean that the trust can now distribute assessable net income. The trustee can still only distribute trust law income – it is just that trust law income now equals the same thing as the Tax Act defines as assessable net income.
Determining trust law income each year

_PRACTICAL NOTE_: For practical purposes this means that trust distributions must always refer to trust law income – as defined in the trust deed.

If a distribution minute refers to taxable income, or assessable net income, etc, then the distribution may not be effective.

_PRACTICAL NOTE_: Distribution minutes should refer to the meaning of trust law income in the trust deed, i.e. how the trustee has calculated trust law income. If there is not a fixed meaning in the trust deed, then the trustee must exercise its discretion to nominate how trust law income is to be determined. The exercise of this discretion must be included in the distribution minutes, or in separate minutes maintained by the trustee.

Importantly, if the trust deed does not provide the trustee with discretion to nominate what makes up trust law income, then the trustee must determine trust law income in accordance with the formula or according to the principles adopted in the trust deed. If no formula or principles are explicitly nominated in the trust deed, then the trustee must adopt the common law notion of trust law income.

_AMENDMENT_: Many people amend trust deeds to give the trustee the discretion to determine what makes up trust law income. Furthermore, many people also nominate a default basis for calculating trust law income, namely the same basis on which assessable net income is determined.

The relevance of trust accounts

It is common practice to prepare ‘trust accounts’.

Trust accounts are usually based on accounting principles. Accounting principles do not necessarily match the trust deed definition of trust law income, or the Tax Act definition of assessable net income. Accounting income introduces a third category of ‘income’ into the mix.

Usually the trust accounts and the trust tax return are the only documents prepared by the trustee. Rarely, if ever, do trustees prepare a statement of ‘trust law income’. Furthermore, often the numbers in the trust accounts are adopted in the distribution minutes. If this is the case, the trust deed must allow the trustee to determine trust law income on the basis of the principles adopted in preparing the trust accounts. This should be minuted, if the trust accounts are being relied on.

If trust law income is defined to match assessable ‘net income’ – i.e. what is in the trust’s tax return, then the use of the accounting figures in the distribution minutes is incorrect. This is because the distribution minutes are then distributing accounting income – which does not match trust law income – and the trustee can only distribute trust law income. Everything must always come back to the definition of trust law income – because the trustee can only distribute trust law income.

_PRACTICAL NOTE_: Often in practice trustees do not actually make up a summary of what actually constitutes trust law income for each year. Instead they adopt the trust accounts. If this is the case, then you need to ensure that both the trust deed and your minutes reflect this. In most cases this is not problematic. It can be if accounting income is negative, or does not include capital gains, etc.

Distributing trust law income

_IMPORTANT_: The distribution minutes must then distribute trust law income.
The distribution minutes should not attempt to distribute accounting income, assessable net income, or any other concept, other than the concept of trust law income (as defined in the trust deed).

Unless it is specified otherwise in the trust deed, the trustee may distribute trust law income to beneficiaries by way of a percentage or proportion of trust law income, or by referring to a specific amount, with the balance being appointed to another beneficiary.

e.g. $10,000 to mum, $20,000 to dad, and the balance of trust law income to a family company. Alternatively, 30% to mum, 30% to dad and 40% to a family company.

What happens to the assessable net income?

Tax is imposed with reference to the beneficiary’s ‘assessable income’. A beneficiary’s assessable income includes their share of any trust ‘net income’ to which the beneficiary is presently entitled.

As noted above, a beneficiary is not able to be presently entitled to net income. The beneficiary can only be entitled to trust law income. This is really the heart of the problem with taxing trusts.

This requires a ‘link’ to be made between trust law income (which a trustee can distribute, and which a beneficiary can be entitled to), and net income (which is a theoretical concept defined in the Tax Act).

The link takes the form of the ‘proportionate approach’. The proportionate approach is really a principle which is used to link a trust law concept with a tax law concept. The proportionate approach says that a beneficiary who is entitled to a proportion of trust law income will be entitled to the same proportion of tax law net income.

e.g. if trust law income is $3,000, and net income is $1,800, then a beneficiary entitled to $2,000 of trust law income (two thirds of trust law income) will be taken to be entitled to $1,200 of net income (two thirds of net income).

What happens if there is no trust law income (or a trust loss), but there is positive net income or credits?

If there is no trust law income, or there is negative trust law income (i.e. a trust loss), then it is not possible for the trustee to make any distribution. The trustee cannot distribute something that does not exist at law.

However, even if the trust has no trust law income, it may nevertheless still have net income for tax purposes. This may be because net income includes something that is not included in the common law definition of trust law income, for example, franking credits, foreign tax credits, and capital gains.

If this occurs, then the net income will get ‘stuck’ in the trust. This is because if there is no beneficiary with an interest in trust law income, then the proportion is ‘nil’. Therefore no beneficiary will be taken to be entitled to any proportion of net income for tax law purposes.

People get around this problem by defining trust law income to include these ‘notional’ tax law amounts. Therefore trust law income will be positive, which will enable a distribution that will take with it the relevant proportion of tax law net income through to a beneficiary.
TR 2012/D1 was issued on 28 March 2012. This Draft Ruling is about the meaning of ‘income of the trust estate’ in Division 6, i.e. trust law income. Paragraph 13 of this Draft Ruling states that notwithstanding how a particular trust deed may define trust law income, the meaning of the ‘income of the trust estate’ for Division 6 purposes cannot exceed ‘real income’.

The purpose of this position is to prevent a trustee from including notional amounts (such as franking credits, etc) in the calculation of trust law income. It is arguable whether or not it is possible for the ATO to take this position without a fundamental change to trust law. However, in relation to franking credits and capital gains, this has now been alleviated by the specific streaming provisions (see below).

**Is it possible to deal with ‘categories’ of trust law income?**

For some time trustees have sought to distribute certain discrete ‘categories’ of trust law income to specific beneficiaries in specific proportions, for example, to distribute foreign income, dividends, capital gains and other income to different beneficiaries. These categories of trust law income usually matched a particular category of assessable income. This has been referred to as ‘streaming’.

**AMENDMENT:** Streaming is only possible for trust law purposes if the trust deed allows for the streaming of trust law income. This requires the trust deed to provide the trustee with authority to identify, separately account for and separately distribute these different components of trust law income.

Up to 2011 the ATO accepted that if the trust deed allowed for streaming of trust law income, then this would be accepted for tax law purposes. Furthermore, the ATO accepted that streaming could be effective in relation to notional amounts, such as franking credits, foreign tax credits, withheld tax, capital gains tax concessional amounts, etc. The streaming could take place either absolutely or proportionately, i.e. one beneficiary could get all of a particularly category of trust law income, or a number of beneficiaries could share in a proportion of a particular class.

As from 2011 the tax law position has changed (see **Tax Laws Amendment (2011 Measures No. 5) Act 2011**). The tax law only recognises the streaming of certain limited categories of net income. This has not changed the trust law position. But because most streaming was tax-driven, the changes to the tax law have impact.

As from 2011 only dividend income and capital gains can be subject to effective streaming for tax law purposes. The effect of the legislation is to remove capital gains and franked distributions from being assessed to a beneficiary under Division 6 of ITAA 1936, and now have them assessed under subdivision 115-C of the Tax Act 97 (Capital gains) and subdivision 207-B of the Tax Act 97 (Franked distributions). All capital gains and franked distributions are now assessed to a beneficiary of a trust under subdivision 115-C and subdivision 207-B respectively, regardless of whether the trustee streams them or not.

**How is a ‘capital gain’ effectively distributed?**

First the capital gain must be calculated by the trustee.

The trustee can then either distribute the capital gain as part of a general distributions of net income, or the trustee can elect to stream capital gains to one or more specific beneficiaries (subject to the authority in the trust deed).
In order to effectively stream under subdivision 115-C of the Tax Act 97, the trustee must distribute a real financial benefit equal to the total of the underlying capital gain – before concessions. It is not possible just to distribute the net assessable gain.

**When must trust law income be distributed?**

It has always been a trust law requirement that trust law income be distributed to beneficiaries before the end of each accounting period for the trust.

If the trust law income was not distributed before the end of the accounting period then either the trust law income was subject to a default distribution under the trust deed, or was accumulated to corpus.

However, for some time the ATO accepted that trustees could take up to 2 months to finalise accounts and put in place distribution minutes. This concession was withdrawn in 2011, along with the withdrawal of IT 328 and IT 329.

Most trust deeds also provide that the trustee can make interim distributions of trust law income throughout the year. This is only possible if the trustee has the authority to effectively break the accounting period up into sub-periods, and to determine the extent of trust law income for the relevant sub-period. An interim distribution, if it can be made, must be minuted in the same manner as end-of-year distributions.

**Who can trust law income be distributed to?**

The trustee can only distribute trust law income to a person who qualifies as a beneficiary under the trust deed. A common mistake that people make is to attempt to distribute trust law income to someone who is not a beneficiary under the trust deed. You can only make distributions of trust law income to trust beneficiaries.

**Who can make distributions?**

Only the current trustee of the trust can make valid distributions to beneficiaries of the trust. The valid trustee of the trust should be identified at the relevant time, i.e. during the year in the case of an interim distribution, or at year end for final distributions.

Where there is a corporate trustee, the Directors of the trustee company can attend a meeting including by telephone as contemplated by section 248D of Corporations Act 2001. Alternatively all Directors can sign a circulating resolution under section 248A Corporations Act 2001. The resolution is passed when the last director signs 248A(3). The advantage of a circulating resolution is that an actual meeting does not have to be held.

Under section 251A(1) of the Corporations Act 2001, a minute or resolution can be inserted into the minute book up to one month after the resolution is passed. If a resolution is passed on 30 June the minute can be prepared and signed by 31 July. Section 248B in relation to sole director companies states that a sole director may pass a resolution by recording it and signing the record.

Whilst the ATO has stated that, unless the trust deed requires otherwise, it will accept records created after 30 June as evidence of the making of a resolution by that date to create present entitlement, the best practice, is to have the signed resolutions completed before 30 June so there is no doubt if queried by the ATO.
What happens if a distribution is not made or is ineffective?
If a distribution of trust law income is ineffective at law, then the trust law income is either accumulated into corpus, or may have been subject to a default distribution provision under the trust deed.

For tax purposes, the relevant proportion of assessable net income will follow what happened to the trust law income.

What happens if net income is amended in the future?
The High Court in Bamford held that the amended net income of the trust did not flow to the “balance” beneficiary, being the Church of Scientology. Instead the net income in section 95(1) of the trust was taxed to the beneficiaries in proportion to the trust law income already appointed to them. Accordingly, some commentators feel that any attempt to direct additional section 95(1) income, as a result of a tax audit, will not be effective.

However, complexity arises when trust law income is defined as matching tax net income. The argument goes that if there is an amendment to tax net income, this automatically flows through to adjust trust law income. We do not consider that this point was directly considered by the High Court in Bamford.

Draft Taxation Determination TD 2012/D5, dealing with the proportionate approach, provides examples where after lodgement the ATO increases the trust’s section 95(1) income (its distributable income), and this increase flows through to a ‘balance beneficiary’ (Example 3), which provides a more manageable outcome.