BEN SYMONS

BARRISTER – STATE CHAMBERS

PRESENTED TO THE CPA TAX DISCUSSIONS GROUP CASTLE HILL – MAY 2017

Discretionary family trusts

Advantages

- Good asset protection – particularly with a corporate trustee:
  (i) Assets not held in personal name;
  (ii) Mere possibility/expectancy in relation to distributions.
- Flexible distributions to beneficiaries to maximise tax efficiency
- Access to 50% 12-month CGT discount
- Ability to stream capital gains and franked dividends
- Ability to make family trust election

Disadvantages

- Risk of resettlement – changes to beneficiaries and trust property
- Losses trapped in trust – cannot be distributed;
- Land tax / CGT – no primary residence exemption for residence held in trust;
- In NSW, the Succession Act claws back transactions with a trust that the deceased controls.
- Consider whether suitable to access small business CGT concessions

Unit trust

Advantages

- Allows for proportionate ownership – therefore proportionate interest in capital and income of trust;
- Most suited to business dealings with unrelated parties;
- Access to 50% 12-month CGT discount

Disadvantages

- Poor asset protection – assets in trust protected, but units of the unit holder are not
- Losses trapped in trust – cannot be distributed;
- Land tax / CGT – no primary residence exemption for residence held in trust;
- In NSW, the Succession Act can claws back transactions with a trust
- Consider whether suitable to access small business CGT concessions
- Punitive trust loss rules

Testamentary trusts – tax advantages

- Now typically a standard clause in most wills – a trust created by will upon death
- Tax advantage: can distribute income to resident minors (aged less than 18) at preferential marginal tax rates (excepted trust income within sec 102AG ITAA 1936)
    (i) 0% tax on distributions up to 18,200
    (ii) Highest marginal tax rate of 47% (plus Medicare levy) only reached when distribution exceeds $180,000 +
- In comparison, distributions to minor beneficiaries from *inter-vivos* trusts taxed at penalty rates of 47% (plus Medicare levy)
- Worked example: a widow on $100,000 income with 5 children; non-super estate of $80,000 (2015/2016 y

Scenario	Effective tax rate	Tax paid
Tax on $80K paid to widow	37% on widow	$29,600
Tax on $80K distributed to children by existing family trust	49% on children	$39,200
Tax on $80 distributed to children by testamentary trust	0% on children	$0

Child Maintenance Trusts

- Essentially a discretionary family trust established on the breakdown of parents relationship to provide income to children – children are tax at marginal rates rather than punitive rates;
- In order to establish this trust, the following requirements must be met:
  (a) The trust must be a court order /determination / assessment that their relationship has broken down;
  (b) The effect of this court order / determination is that at least one parent must be under an obligation to provide for maintenance of the children (this could include a child parented in something other than a marriage / de-facto relationship);
  (c) At least one of the parents must have custody of the children;
  (d) The property transferred should be in discharge of this court order / assessment / determination;
  (e) the capital and income thereto, should be held for the benefit of the children (the capital should vest in the children on vesting date).
- CGT payable on transfer of assets in to trust;
- Stamp duty payable on property transferred in to trust
- Trust only suitable where parents agreeable / cooperative

Superannuation proceeds trusts

- Trust set up, preferably under will, to hold superannuation money after death
- Ideally should be established under a will (otherwise ATO may not respect that income distributions to minor beneficiaries is “excepted trust income”)
- Similar tax advantages to a testamentary trust
- Generally set up to segregate ‘death benefit dependents’ from other beneficiaries
- Not that all capital beneficiaries of the superannuation proceeds trust must be death benefit dependents.

Family trust election

- Generally it is wise not to make a family trust election unless necessary;
- It is generally beneficial for a family trust to make the family trust election where it wishes to either

  (a) utilise carry forward losses -simplified COT test;

  (b) streamed franked dividends to beneficiaries.

Family Trust Election

Advantages

- General beneficial to make election if making distributions to a “family” group;
- More generous loss and bad debt utilisation rules (simplified COT, most trust loss rules do not apply)
- Generally the best way to maximise franked dividends for beneficiaries

Disadvantages

- Punitive tax at 47% (plus Medicare levy) on distributions made to beneficiaries outside “family” group
- Class of beneficiaries restricted - “Family group” determined by reference to a “specified individual” – election of a “specified individual” can only be changed once
- “Family group”:

  (i) parent, grandparent, brother or sister of the test individual;

  (ii) nephew, niece, child and their lineal descendants;

  (iii) The spouses of any of the above.

Streaming of capital gains/ franking credits

- *Federal Commission of Taxation v Greenbatch* [2012] FCAFC 84 held that it was not possible to stream capital gains to beneficiaries;
- ATO DIS *Commissioner of Taxation v Bamford & Ors* [2010] HCA 10 says that the ATO will generally respect capital gains and franked dividends streamed to beneficiaries;
- The Federal Government introduced specific legislation to allow capital gains and franked dividends to be streamed to beneficiaries for income years starting 1 July 2010 onwards;
- However, trust deed must specifically empower trustee to distinguish between franked and unfranked dividend distributions
- If not, may need to consider amending trust deed
- Take care in drafting a resolution to stream capital gains or franked dividends;
- Trustee must specifically record distributions of franked dividends / gains in its account; and
- Anti-avoidance rules apply to tax-exempt beneficiaries

Streaming of capital gains

- Are capital gains included within the definition of "net income"? If not, they will need to be distributed under the capital distribution power – take care;
- The financial benefit received by the beneficiary must be referable to the capital gain;
- Take care to deduct any capital losses against a specific capital gain;
- Discount capital gains should be streamed to individuals and trusts (not companies because companies are not entitled to the automatic CGT discount);
- Notional capital gains (e.g. where the market value substitution rule applies, arising from a resettlement of the trust) cannot be streamed;
- Resolution must be passed by 31 August following 30 June for the relevant income year
- Allocation of the capital gain to a beneficiary must be specifically recorded in the trustee's books

Streaming of franked dividends

- Deduct any expenses relevant to the franked distribution;
- Franked dividends can be pooled if they are treated as being of a single class (section 207-59 ITAA 1997);
- The resolution must be passed by 30 June;
- The streamed dividends to certain beneficiaries should be recorded in the trustee's accounts;
- Example: Rich Family Trust has $20,000 of fully franked dividends, $20,000 dividend (50% franked), interest expenses of $4,000 incurred to borrow the shares that generated these dividends, beneficiaries A and B;
- Answer: before 30 June the trustee passes a resolution to pool the dividends so that there are $40,000 of dividends franked 75% - they can be streamed to beneficiary A or B

Drafting a resolution – traps for the unwary

- Take care to identify whether the income is "income" or "capital" for trust purposes (and which power you are exercising under the trust deed);
- Describe whether it is a capital gain of franked dividend being streamed;
- Expressly link the capital gain of franked dividend to the distribution being made to a particular beneficiary;
- For dividends, ensure resolution passed by 30 June;
- For capital gains by 31 August;
- Ensure a distribution of a capital gain or franked dividend is recorded in the books of the trustee.
- If the small business CGT concessions are being claimed, ensure that the relevant beneficiaries have at least a 20% interest in the trust (they receive at least 20% of the income and 20% of the capital)

In-specie distribution of an asset

- CGT event E5 will be triggered for the trustee (and possibly also for the beneficiary if they have some entitlement to the trust corpus that is being distributed);
- The market value substitution rule deems capital proceeds;
- Capital gain = market value of asset less cost base;
- the capital gain will be derived by subtracting the cost base of the asset;
- The trustee should have sufficient funds to cover the tax liability unless:
  - There is a loss on the asset;
  - The trust has carry forward losses that can soak up the gain.
- A beneficiary is an "associate" of a trust for the purposes of Division 72 of the GST Act, and therefore GST is payable on an in-specie distribution of an asset to a beneficiary

Capital (cash) distributions to beneficiaries

- Discretionary trust: section 99B may apply to beneficiaries of non-resident trust estates to include an amount in their income (but not to beneficiaries of resident trust estates);
- CGT event E4 may be applicable to unit trusts (but not discretionary trusts);
- CGT event E4 will apply where a payment is made to a beneficiary and some part of the payment is not included in their assessable income (excluding an amount not taxed under the automatic 50% CGT discount);
- CGT event E4 applies to reduce the cost base of the unit holders units in the unit trust;
- If the unit holders cost base is reduced to less than zero, a capital gain arises to the unit holder in respect of the excess

Interim capital distribution from asset revaluation reserve

- A beneficiary that wants to exit a trust can be paid an interim capital distribution from an asset revaluation reserve;
- The recent High Court case of *Fischer v Nemeske* (2016) 330 ALR 1 considered that this was feasible, but care needs to be taken in implementing this;
- In *Fisher v Nemeske* (2016) 330 ALR 1
  - (i) The Nemese family trust held a single asset being shares in a company called Aladdin;
  - (ii) In September 1994, the trustee created an asset revaluation reserve in respect of these shares in the amount of $3,904,300;
  - (iii) The trustee made an interim capital distribution out of the account to the two designated beneficiaries , Mr and Mrs Nemes;
  - (iv) The trustee made this distribution by crediting this amount in its accounts and passed a resolution on 23 September 1994 making this resolution;
  - (v) The trustee executed a "Deed of Charge" over the shares on 30 August 1995 in favour of Mr and Mrs Nemes;
  - (vi) Mrs Nemes passed away on 9 November 2010 and Mr Nemes passed away 0n 26 September 2011;
  - (vii) Mr Nemes left all of the shares of Alladin to "the Fischers"
  - (viii) The Fiscjhers sought to challenge the validity of the distribution to Mr Nemes (now represented by his executor)
- In a 3:2 majority decision the High Court held in this case that the resolution of distribution and Deed of Charge in favour of Mr and Mrs Nemes was sufficient to secure the distribution for them (and their estates).

Amendment of trust deed – will it trigger a resettlement / capital gain?

- Amending a trust deed may trigger a resettlement
- May trigger capital gains and stamp duty liability
- Must be able to demonstrate some degree in the continuum of:
  - (i) Constitution / regime of trust obligations affecting property
  - (ii) Trust property;
  - (iii) Members / objects of trust

  (Federal Commissioner of Taxation v Clarke (2011) 190 FCR 206 and Federal Commissioner of Taxation v Commercial Nominees (2001) 47 ATR 220)
- Strict or partial identify not required – (Federal Commissioner of Taxation v Clarke (2011) 190 FCR 206);
- Generally, as long as any amendment to the trust deed is made in accordance with the power permitting the amendment of the original trust obligations, and there is continuity of trust property in relation to those obligations, the original trust will continue; and
- However, there is still uncertainty as to when a resettlement might be triggered

What will trigger a resettlement? (cont'd)

- However, amending a trust deed such that certain assets are held for certain beneficiaries will result in a resettlement (ATO view in TD 2012/21 per Nettle JA in Commissioner of *State Revenue v. Lam & Kym Pty Ltd [2004] VSCA 204,* see also Edmonds J in *Oswal v Commissioner of Taxation [2013] FCA 745);*
- Care needs to be taken amending a beneficiaries rights to income or capital of the trust – this could potentially trigger a resettlement.

Amendments that will not result in a resettlement

- TD 2012/21 indicates that amending a trust deed to add beneficiaries or allow streaming of capital gains and franked dividends would generally not of itself trigger a resettlement;
- TD 2012/21 addendum – indicates that amending the termination date of the trust from 31 March 2021 to 31 March 2051 which wides the class of beneficiaries does not constitute a resettlement of the trust

Trust loss rules

- The table below sets out the tests (conjunctively) that each type of trust must satisfy:
  (i) Conjunctively (all tests marked "Yes" must be satisfied);
  (ii) From the start of the loss year to the end of the income year in which the loss is sought to be utilised (the **"test time"**) (at all times unless otherwise stated):

	Discretionary trust	**Family Trust**	**Unit trust (non-fixed)**
50% stake test	Yes	Yes (modified)	Yes
Pattern of distribution test	Yes	No	Yes
Control test	No	No	Yes
Same business test	Yes	No	No
Income injection test	Yes	Yes (modified)	Yes

Trust loss rules – 50% stake test

- **50% stake test (fixed trusts):** individuals directly or indirectly (through an interpose entity) must have an entitlement to more than a 50% share of the income or capital of the trust at all times or at two times;
  - (i) No need to trace through complying superannuation funds, government bodies, family trusts or interposes listed public companies
- The 50% stake test applies to non-fixed trusts – in most situations it won't apply:
  - (i) it may potentially apply where a beneficiary had an entitlement to the corpus of the trust (which is generally unusual)

Trust loss rules – Pattern of distributions test

- The most difficult test to satisfy;
- The test is passed where, within 2 months of the end of the "test" income year, the trust distributed greater than 50% of its income and capital to the same individual beneficiaries for all income years:

  (i) as far back 6 years before the start of test income year;

  (ii) certainly from the income year just before the loss year and any income years up until the test income year;
- Where an individual beneficiary has received a different percentage distribution through the test time, then the smallest percentage distribution for any of the test income years

Trust loss rules – control test

- A group (a person and their associates) must control the trust from the start of the loss year until the end of the income year in which the loss is sought to be utilised (section 266-150 in conjunction with section 267-45 of the ITAA 1997);
- A group controls a trust where:

  (i) the group has the power to obtain directly or indirectly beneficial enjoyment of the capital or income of the trust;

  (ii) the group directly or indirectly controls the application of the capital or income of the trust;

  (iii) the trustee is accustomed or might reasonably be expected to act in accordance with the wishes of the group;

  (iv) the group is able to remove or appoint the trustee;

  (v) the group acquires more than a 50% stake in the income or capital of the trust.
- Where an individual becomes part of the group because of death, incapacitation of break down of marriage of one of the original group members, they will be treated as being part of the original group.

Trust loss rules – same business test

- A listed widely held trust passes the same business test if it carried on the same business from the start of the loss year until the end of the income year in which the loss is sought to be utilised.
- A listed widely held trust does not carry on the same business if it derives assessable income:

  (i) from a business that it did not carry out before the test time;

  (ii) from a transaction that it had not entered in to in the course of its business operations before the test time.
- A **modified test** applies for a **"family trust"** – effectively the trustee or beneficiaries forming part of the family group are <u>not</u> "outsiders" and can inject income in to the trust

Trust loss rules – income injection test

- Fixed and non-fixed trusts need to satisfy the income injection test;
- Family trusts do not need to satisfy the income injection test;
- Broadly, this test is failed where a trust has an allowable deduction / loss and there is a scheme such that the trust derives assessable income to utilise this deduction / loss;
- There will be a scheme where:
  - (i) The trust derives assessable income;
  - (ii) An outsider provides a benefit to the trustee;
  - (iii) The trustee or beneficiary provides a benefit to an outsider

  And it is reasonable to conclude that the benefit was provided because the deduction would be allowable.

Seeking judicial advice

- A trustee may apply to a court pursuant to section 63 of the *Trustee Act 1925* (NSW) for judicial advice on a question they are uncertain about where it relates to:
  (i) Administration of the trust estate;
  (ii) Interpretation of a trust instrument.
- The primary purpose of judicial advice is to determine what is in the best interests of a trust estate, not determine the substantive issue in an adversarial proceeding (*Macedonian Orthodox Community Church St Petka Incorporated v Bishop Petar* [2008] HCA 42 {105]-[105]);
- Trustee must form their own view in seeking judicial advice from a court – this usually involves seeking counsel's opinion

Seeking judicial advice

- The court is better assisted when advice is sought from counsel;
- Some examples of where a trustee might seek judicial advice:
  (i) SMSF where either the husband or wife passes away, and there is doubt as to whether the superannuation money should be paid to the remaining spouse;
  (ii) A trust deed is lost and advice needs to be sought for a court to reconstruct the trust deed;
  (iii) There is prospective litigation against the trust – advice should be sought on whether the trustee should defend the proceedings;
  (iv) The trustee may have a potential conflict between competing classes of beneficiaries in relation to the way they exercise their discretion.

What to do about a "lost" trust deed?

- Try and locate a signed copy of the original trust deed:
  (i) Inquire whether the trustee, the former trustee / trustee directors, the settlor or beneficiaries have a copy of the deed;
  (ii) Inquire with any relevant "safe keeping" organisation;
  (iii) Inquire with professional advisor who may have been involved drafting the deed (e.g. lawyers, accountants etc.)
- Ideally the above will turn up at least an unsigned copy of the original trust deed:
  (i) An application can then be made to the court to declare that this copy stand in the place of the original trust deed; and
  (ii) Affidavit evidence will need to be adduced from relevant witnesses as to the terms of the original trust deed (and therefore whether the unsigned copy can stand in the place of the original trust deed).

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