

# TRUSTS DEEDS: DRAFTING, VARYING AND GETTING IT RIGHT

**A paper presented by Michael Bennett for the University of New South Wales**

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<b>1 Overview.....</b>	<b>4</b>
1.1 A Trust .....	4
1.2 Types of Trusts.....	5
1.2.1 Discretionary Trusts.....	5
1.2.2 Unit Trusts.....	6
1.2.3 Fixed Trusts.....	8
1.2.4 Bare Trusts.....	9
1.2.5 Hybrid Trusts .....	10
1.3 The Court’s Reminders .....	11
1.4 Professionals’ Obligations in relation to Trusts .....	12
<b>2 Interests of a Beneficiary .....</b>	<b>14</b>
2.1 The Nature of the Interest .....	14
2.2 The Trustee’s Right of Indemnity .....	16
<b>3 Desirable Provisions in a Modern Trust Deed.....</b>	<b>17</b>
3.1 Annual Deadline for Income Distributions .....	17
3.2 Trustee’s Discretion to Determine Net Income .....	18
3.3 Allowing Distributions from Gross Income to Preserve Franking Credits.....	19
3.4 Excluding Notional Amounts of Income .....	19
3.5 Dealing with Unpaid Present Entitlements .....	20
3.6 Specific Entitlement to Future Capital Gains.....	21
3.7 Asset Revaluation Reserves .....	21
3.8 Streaming Provisions .....	21
3.9 Breaches of a Family Trust Election.....	21
3.10 Accessing the Small Business Concessions.....	22
3.11 The Trustee’s as a Beneficiary .....	23
3.12 Distributions to other Trusts: Perpetuity & Character of Receipt.....	23
<b>4 Effecting Distributions .....</b>	<b>23</b>
4.1 A Proposed Checklist.....	23
4.2 Time of Decision.....	25
4.3 Means of Making the Decision or Resolution.....	25
4.4 Trustee’s Duty in a Discretionary Power .....	26
4.4.1 <i>Can the trustee’s decision be reviewed?</i> .....	26
4.4.2 <i>The Karger v Paul Test</i> .....	28
<b>5 Streaming .....</b>	<b>30</b>
5.1 Capital Gains.....	30
5.2 Franking Credits.....	32
5.3 Absence of streaming provision.....	34
5.4 Terms to be Provided for in a Trust Document.....	34
5.4.1 <i>Accounting policy</i> .....	35
5.4.2 <i>Reclassifying and allocating income and capital</i> .....	35
5.4.3 <i>Reclassifying and allocating outgoings</i> .....	36
5.4.4 <i>Discretion not to recoup losses (whether income or capital in nature)</i> .....	37
<b>6 CGT Event E4.....</b>	<b>37</b>
6.1 CGT Event E4 .....	37
6.2 Strategies to Deal with It.....	38
6.2.1 <i>First Strategy to Deal with It</i> .....	38
6.2.2 <i>Second Strategy to Deal with It</i> .....	38
<b>7 Asset Revaluation Reserves .....</b>	<b>39</b>
7.1 Section 99B .....	39
7.2 Two Problems with the Asses Revaluation Proposal.....	41
7.3 Accounting Treatment Imperative .....	41

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<b>8</b>	<b>Trust to Trust Distributions</b> .....	<b>43</b>
8.1	Ensure they're a beneficiary.....	43
8.2	Rules Against Perpetuities .....	43
8.3	Family Trust Distributions Tax.....	44
<b>9</b>	<b>Family Trust Elections &amp; Interposed Entity Elections</b> .....	<b>45</b>
9.1	Family Trust Elections .....	45
9.1.1	<i>Family Group</i> .....	45
9.1.2	<i>Family Control Test</i> .....	47
9.1.3	<i>Only one election to be made</i> .....	48
9.1.4	<i>Rectification of mistaken choice of test individual</i> .....	48
9.2	Interposed Entity Elections .....	48
<b>10</b>	<b>Implications of Failed Distributions</b> .....	<b>49</b>
10.1	The distributing trustee .....	49
10.2	The recipient.....	50
<b>11</b>	<b>Reimbursement Agreements</b> .....	<b>50</b>
11.1	Reimbursement Agreements .....	50
11.2	Corporate beneficiary .....	51
11.3	Wholly Owned Corporate Beneficiary.....	52
<b>12</b>	<b>Amending a Trust Deed</b> .....	<b>53</b>
12.1	Amending Generally .....	53
12.2	Re Dion .....	55
12.2.1	<i>Background</i> .....	55
12.2.2	<i>What is a transaction?</i> .....	57
12.2.3	<i>Overriding or supplementing – no variation</i> .....	59
12.2.4	<i>Terms of Trust vs Trust Deed</i> .....	59
12.2.5	<i>Value of Trust Fund for Leave to Appeal</i> .....	60
12.2.6	<i>Conclusion on Re Dion</i> .....	61

## 1 Overview

This paper will focus on the drafting of trusts. But because the passage of time and the amendment of legislation can change the appropriate requirements of a trust, the issue of trust amendments will also be considered.

In doing so it is convenient to consider some specific issues relevant to modern trust deeds; a general discussion of trust deeds would not be as useful as the more focused, but detailed, approach.

There are many categories of trusts: for instance see paragraph 1.2 below. But by far the most commonly used in Australia is what is referred to as discretionary trust.<sup>1</sup> This description is not defined in legislation – whether it be the income tax legislation, duties legislation or the relevant trustee acts – or in the case law.

The Courts have repeatedly told us that there is no such thing as a “discretionary trust” or a “unit trust” (for instance), but merely the particular trust based on the particular deed under consideration: see paragraph 1.3 below. This can cause concern for practitioners as there are various templates in circulation that may lead into complacency as to a thorough understanding of the trust terms based on nothing more than a potentially previous reading of a similar, deed from another trust.

### 1.1 A Trust

Broadly a trust is a relationship in relation to identified property; it is not an entity.<sup>2</sup> It is a relationship between the legal owner (the trustee) of property (the trust property) and the beneficial owner or owners of that property (the beneficiaries) to whom the trustee owes obligations.

Most trusts are intentionally created and usually the terms of the trust are found in the trust deed. It is the distributions of this type of trust (an express trust) that is the subject of this paper.

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<sup>1</sup> I use the term here, and in relation to the second trust, for descriptive purposes only, and not as determinative of the terms of the trust – see the High Court’s caution in this regard in *MSP Nominees Pty Ltd v Commissioner of*

<sup>2</sup> Though legislation at times will deem a trust to be an entity for the purposes of that legislation: see ss 960-100(1) and 995-1 of the *Income Tax Assessment Act 1997* (Cth) (the ‘1997 Act’), which defines ‘entity’ as including a trust; see also ss 184-1 and 195-1 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) that are to the same effect.

However, that is not to say that non-express trusts, such as a resulting trust or a constructive trust, are not relevant to considerations of distributions or matters arising in a taxing context. Indeed, cases in a taxing context show how important the trust principles discussed herein are to the subsequent consideration of tax law issues:

- (a) In a land tax context Dixon J said in *Stewart Dawson & Co (Victoria) Pty Ltd v FC of T* (1933) 48 CLR 683 at 691 that he could see ‘*no reason why [an equity] rule should not apply in revenue matters. If liability for tax depends upon the existence or non-existence of a trust, the occasion seems to demand the application of the rules by which the determination of such questions are governed in Courts of equity.*’
- (b) In *MacFarland v FC of T* (1986) 13 FCR 356 Beamont J, when referring to the effect of a constructive trust on income derivation, said that it was an error to say that for the purposes of the income tax law that ‘*the legal title to income is determinative. The Act ... takes the taxpayer’s income as it finds it – that is to say, subject to the general law in all its aspects. This will pick up the position at law and in equity, modified by any relevant legislation, including the provisions of the Act itself.*’

It follows that the proper equitable principles governing trusts are the fundamental starting point in an analysis of distributions issues.

## 1.2 Types of Trusts

Subject to the warning in paragraph 1.3 below, it can be said there are a variety of types of express trusts. The commonly<sup>3</sup> referred to ones are as follows.

### 1.2.1 Discretionary Trusts

Discretionary trusts, on which this paper will focus, are so called because of the discretion or power conferred on the trustee in dealing with or distributing the beneficial interests in the trust estate. Those discretions will usually include:

- (a) discretion to select from the designated range of objects of the trust those who are to receive benefits of income, capital or both;
- (b) an accompanying power to decide the amount or proportion of income or capital to be allocated to the selected object or objects; and

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<sup>3</sup> There are also charitable trusts, blind trusts, custodian trustees, trading trusts and other more exotic descriptors.

- (c) a power to decide not to allocate benefits to some objects or, indeed, to allocate benefits to one object to the exclusion of all others.

In addition to those powers there is sometimes an additional discretion: a power to add to or remove from the designated range of objects.

In a discretionary trust no beneficiary (other than default beneficiaries' whose interests are contingent) has any entitlement to any specific part of the trust property unless and until the trustee decides to allocate some or all of the income or capital to that beneficiary. Prior to making that decision, the rights of the beneficiary, known as a mere object, are restricted to a right to be considered for nomination by the trustee and to compel proper administration of the trust: *Gartside v IRC* [1968] AC 553. The interest of an object of a discretionary trust is thus not an 'interest in possession' and can be best described as a 'mere expectancy': *Pearson v IRC* [1981] AC 753.

Two lengthy passages that discuss the nature of a discretionary trust and a fixed trust are those of Gummow J in *FCT v Vegners* (1989) 90 ALR 547 at 551-552 and the Full Court of the Federal Court in *FCT v Ramsden* [2005] FCAFC 39 at [32] at heading 1.3 below.

Subject to the case mentioned at the end of this paragraph, neither the objects of discretionary powers nor the members of a class of beneficiaries of a discretionary trust have any right to demand a distribution in their favour. Both have an 'interest' in the assets of the trust in the sense that they can enforce due administration of the trust. They are entitled to information about the trust: *Spellson v George* (1987) 11 NSWLR 300; *Tierney v King* [1893] 2 Qd R 580. But they are not entitled as of right to inspect the trust books and records: *Silkman, Forise Enid v Shakespeare Haney Securities Limited (ACN 087 437 783 (in its capacity as responsible entity of the Shakespeare Haney Premium Income Fund (ARSN 106 223 483))* [2011] NSWSC 148 per Hammerschlag J. Where the class of objects of a discretionary trust is ascertained (that is, able to be identified and listed), and all of legal age and unanimous, that class of objects combined can call for a distribution: *Sir Moses Montefiore Jewish Home v Howell & Co (No 7) Pty Ltd* [1984] 2 NSWLR 406 at 411 per Kearney J.

### 1.2.2 Unit Trusts

Unit trusts are trusts in which the beneficial interest in the trust is divided into a number of units, whether of one class or multiple classes, which can be sold or issued, as the case may be. The

term ‘unit trust’ is not a scientific term, and will often be misused to refer to a ‘fixed trust’ which carries with certain tax consequences. As to fixed trusts, see heading 1.2.3 that follows.

The term ‘unit trust’ is not prescriptive: see *CPT Custodian Pty Ltd v Commissioner of State Revenue* (2005) 224 CLR 98 at [15] quoted at heading 1.3 below. Despite this, the Commissioner of Taxation states in *Interpretative Decision ATO ID 2010/57*:

There is however a consistent approach to what constitutes a unit trust which can be found in authoritative works. This definition reiterates the concept that the beneficial interest of the trust is held in “units”. Units are expressed and defined as part of the whole beneficial interest of the trust (or in some circumstances of the whole beneficial interest of a particular kind). Other than this “unit trusts” are, like all other trusts, subject to the terms of the impressed or stated trust and to the application of the law of trusts.

Although doubts initially arose about the legality of unit trusts,<sup>4</sup> based on the prohibition on formation of trading partnerships and associates over a certain size, their legitimacy was upheld.<sup>5</sup> It is now clear that properly constituted unit trusts do not contravene this prohibition which, in Australia, is found in s 115 of the *Corporations Act 2001 (Cth)*: *West Merchant Bank Ltd v Rural & Agricultural Management Ltd* (1996) 20 ACSR 563 at 574.

From an beneficiary’s commercial point of view, owning units in a unit trust is the same as owning shares in a company. Legally, however, this is not the case. In *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598 at 609 the High Court said:

[A] unit held under this trust deed is fundamentally different from a share in a company. A share confers upon the holder no legal or equitable interest in the assets of the company; it is a separate piece of property ... But a unit in the trust deed before us confers a proprietary interest in all of the property which for the time being is subject to the trusts of the deed.

Again, it is critical to consider the particular deed.

A significant consequence of being a ‘unit trust’ is the potential application of CGT Event E4, which can result in double taxation. This is discussed further at heading 6 below.

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<sup>4</sup> *Sykes v Beadon* (1879) Ch D 170.

<sup>5</sup> *Smith v Anderson* (1880) 15 Ch D 247.

### 1.2.3 Fixed Trusts

In very simple terms a fixed trust is a trust the beneficial interests in which are fixed. They may be so fixed via unit holdings or other means.

According to the tax definition of a fixed trust, it is one in which beneficiaries have fixed entitlements to the income and the capital of the trust: s 995-1 of the 1997 Act. The term 'fixed entitlement' in this context is defined in the trust loss rules Division 272 of Schedule 2F to the 1936 Act, which provides as follows:

If, under a trust instrument, a beneficiary has a vested and indefeasible interest in a share of the income of the trust that the trust derives from time to time, or of the capital of the trust, the beneficiary has a fixed entitlement to that share of the income or capital.

The term 'indefeasible' takes its ordinary meaning: that it cannot be terminated, invalidated or annulled.

As shown by *Colonial First State Investments Limited v FCT* [2011] FCA 16 – where Stone J considered that because a unit holder's interest could be reduced or detrimentally affected as a result of a special resolution of the unit holders, the unit holder could not be said to have a vested and indefeasible interest – it will be very difficult to establish that a fixed trust exists.

Although, to an extent, beyond the scope of this paper, it is worth noting that whether a trust is a fixed trust may determine, amongst other things:

- (a) availability of franking credits for beneficiaries. Section 207-145 of the 1997 Act provides that a franking credit will only be available in circumstances where the recipient is a qualified person. In the case of a trust, this condition will be satisfied if the trust is a fixed trust or if the trustee has made a family trust election (to which see heading 9 below).
- (b) the ability to utilise tax losses.
- (c) whether income received by a self-managed superannuation fund from an interest in a trust will be non-arm's length income. If that income is from a fixed entitlement to

income it will not be taxed at the higher rates, though see the Commissioner's difficulties in this regard.<sup>6</sup>

- (d) the extent of the application of the value shifting provisions to a transaction.

Given the fixed nature of a beneficiaries' entitlement, fixed trusts will be related to, but not be the focus of, this paper on distributions.

#### 1.2.4 Bare Trusts

The term 'bare trust' is often used to describe a trust in which the trustee has no active duties to perform. However, in *Corumo Holdings Pty Ltd v C Itoh Ltd* (1991) 24 NSWLR 370 at 398 it was pointed out that as a matter of strict logic almost no situation could be contemplated or postulated where a trustee in some circumstance does not have active duties to perform by, for example, being immediately bound to transfer the trust property to the beneficiary who was absolutely entitled to it.

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<sup>6</sup> The policy intent of moving to a self-assessment model – from the “special income” provisions to the “non-arm's length income” provisions – would be significantly undermined by adopting the position that a fixed entitlement for present purposes was defined by reference to the meaning of that term under Schedule 2F to the ITAA 1936 as taxpayers would have to approach the Commissioner for the exercise of his discretion to treat a trust interest as a fixed entitlement which is not administratively distinguishable to approaching the Commissioner to treat special income as ordinary income under the former regime. However, in *The Trustee for MH Ghali Superannuation Fund v FCT* [2012] AATA 527, Egon Fice SM held that the term was defined in Schedule 2F of the ITAA 1936 and covered the meaning of that term for the purposes of the (former) special income rules. In his Decision Impact Statement on *Ghali*, the Commissioner concluded this was in error and that the Trust Loss definition did not apply to the non-arm's length income provisions. The Commissioner said:

“In light of recent authority, it might be said that the fixed entitlement test in Schedule 2F is relatively difficult to satisfy. See, for example, *Colonial First State Investments Ltd v FCT*, and the Commissioner's Decision Impact Statement in respect of that case. Having regard to the strictness of that test, the Commissioner perceives that the adoption of the Schedule 2F definition for the purposes of s 273 (or its successor, s 295-550) would give rise to adverse and unintended impacts on superannuation funds that hold arm's length trust investments.

The Commissioner proposes to adhere to his existing view that the Schedule 2F definition is inapplicable for the purposes of s 273. Although not considered by the Tribunal, we note that the Commissioner's view is that the Schedule 2F definition also does not apply for the purposes of s 295-550: see TR 2006/7 and the minutes to NTLG Superannuation Subcommittee meeting of March 2010.”

Despite the Commissioner's public views on *Ghali* in his DIS, in Private Ruling 1012585947911, the Commissioner ruled that an amount was non-arm's length income applying the definition of a fixed entitlement under Schedule 2F of the ITAA 1936 (that is, the complete opposite to what was publicly stated!).

The critical point is that advisers would be loath to advise on the operation of these provisions in the absence of extraordinarily rigid trust deed or a successful Private Ruling, whether in relation to:

1. the meaning of 'fixed entitlement' for present purposes falling outside the scope of the definition in Schedule 2F of the ITAA 1936; or
2. if the Commissioner seeks to rely on *Ghali* – the exercise of his discretion to treat the relevant interest as a fixed entitlement.

The rights and duties of a bare trustee were articulated by the High Court in its unanimous decision in *CGU Insurance Limited v One.Tel Limited* (2010) 242 CLR 174 at 183:

The trustee of a bare trust has no interests in the trust assets other than those which exist by reason of the office of trustee and the holding of legal title. Further, the trustee of a bare trust has no active duties to perform other than those which exist by virtue of the office of the trustee, with the result that the property awaits transfer to the beneficiaries or awaits some other disposition at their direction.

A bare trust often arises within another kind of trust, where the trustee thereof has declared property of the broader trust it to be held for a particular beneficiary. It is commonly referred to as a sub-trust. The Commissioner of Taxation has embraced the sub-trust in his current approach to Division 7A of the Part III of the 1936 Act and trusts: see *Taxation Ruling* TR 2010/3.

Are bare trust is also relevant to a capital gains tax context because s 106-50 of the 1997 Act provides:

If you are absolutely entitled to a \*CGT asset as against the trustee of a trust (disregarding any legal disability), this Part and Part 3-3 apply to an act done by the trustee in relation to the asset as if you had done it.

That is, the capital gains tax regime will ignore the bare trustee and consider the events to have happened to the beneficiary thereof.

Given the fixed nature of a beneficiaries' entitlement, fixed trusts will be relevant to, but not be the focus of, this paper on distributions.

### **1.2.5 Hybrid Trusts**

A hybrid trust has the elements of both a fixed and a discretionary trust. For example, A and B may have equal entitlements to trust capital while the trustee may have a discretion to accumulate income and transform it into capital or distribute it at their discretion between X, Y and Z. The hybrid nature can be achieved by a unit mechanism or by merely fixing the entitlements.

The Commissioner of Taxation is suspicious of hybrid trust arrangements where there is a possibility that they allow deductions to be used by beneficiaries that may not derive the ultimate economic benefit of the underlying assets: see *Taxation Determination* TD 2009/17. The

Commissioner's Decision Impact Statement concerning his loss in the Full Court of the Federal Court in *Forrest v FCT* (2010) 78 ATR 417 shows he maintains his suspicions.

### 1.3 The Court's Reminders

The Court's have repeatedly reminded us that shorthand references to trusts may be helpful colloquially but are also inaccurate. This is because the trust under consideration will be peculiar based on the terms of its deed. The following cases show how the courts approach the issue nomenclature.

In *MSP Nominees Pty Ltd v Commissioner of Stamps* (1999) 198 CLR 494 at [7] per Gleeson CJ, Guardron, Gummow, Hayne & Callinan JJ said:

The significant provisions made by the Trust Deed for the exercise of powers and discretions by the Trustee with respect to distributions to Unit Holders support the description of the trusts established by the Trust Deed as discretionary trusts.

In *CPT Custodian Pty Ltd v Commissioner of State Revenue* (2005) 224 CLR 98 at [15] Gleeson CJ, McHugh, Gummow, Callinan & Heydon JJ said:

In taking those steps, a priori assumptions as to the nature of unit trusts under the general law and principles of equity would not assist and would be apt to mislead. All depends, as Tamberlin and Hely JJ put it in *Kent v SS "Maria Luisa" (No 2)*, upon the terms of the particular trust. The term "unit trust" is the subject of much exegesis by commentators. However, "unit trust", like "discretionary trust", in the absence of an applicable statutory definition, does not have a constant, fixed normative meaning which can dictate the application to particular facts of the definition in s 3(a) of the *Land Tax Act 1958* (Vic).

On this issue, and in the context of fixed and discretionary trusts, Gummow J said in *FCT v Vegners* (1989) 90 ALR 547 at 551-552:

12. There was some discussion by counsel of the term "discretionary trust" and related terms. A fixed trust is used to describe a species of express trust where all the beneficiaries are ascertainable and their beneficial interest are fixed, there being no discretion in the trustee or any other person to vary the group of beneficiaries or the quantum of their interests. The expression "discretionary trust" is used to identify another species of express trust, one where the entitlement of beneficiaries to income, or to corpus, or both, is not immediately ascertainable. Rather, the beneficiaries are selected from a nominated class by the trustee or some other person and this power may be exercisable once or from time to time. The power of selection is a special or hybrid power; a power exercisable in favour of any person including the donee of the power would be a general power and thus would be tantamount to ownership of the property concerned, whilst the objects of a special power would be limited to some class, and the

objects of a hybrid power would be such that the donee might appoint to anyone except designated classes or groups.

13. The trust will be "purely discretionary" where income and capital may be withheld altogether but this would not be so where the donee of the power of selection had a discretion only as to the time or method of making payments to or for beneficiaries; see Scott on Trusts, 4th Ed., para 155. In this regard, the special or hybrid power would be further classified, or, sub-classified as a trust power or a bare power within the meaning of those expressions as discussed by the House of Lords in *Re Gulbenkian's Settlement Trusts* (1970) AC 508 and *Re Baden's Deed Trusts* [1970] UKHL 1; (1971) AC 424. However, some courts and commentators have used the expression "discretionary trust" only to describe cases where the power involved is a trust power rather than a bare power; see, for example, *Re Baden's Deed Trusts (No. 2)* (1973) Ch 9 at 26 and Hanbury & Maudsley, "Modern Equity", 12 Ed., 1985, pp 199.

14. It will be apparent that unlike the division of trusts between purpose trusts and non-purpose trusts, and between express trusts, implied or resulting trusts and constructive trusts, and the classification of powers between general, special and hybrid powers, and between trust and bare powers, the usage of the term "discretionary trust" is essentially descriptive rather than normative. The meaning of the term is primarily a matter of usage, not doctrine.

More recently the Full Court of the Federal Court observed, in *FCT v Ramsden* [2005] FCAFC 39 at [32]:

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. The term refers to the directions of the creator of the trust which confer the discretion rather than to the instrument in which these directions are contained. A single instrument may contain both discretionary trusts, as well as fixed trusts: Ford & Lee *Principles of the Law of Trusts*.

This has significance in the context of distributions as it should not be assumed that particular distributions are available or unavailable because of the trust's loose description as a particular kind of trust; the terms of the deed that govern the trust must be considered.

#### **1.4 Professionals' Obligations in relation to Trusts**

Accountants and lawyers working with, or advising in relation to, trustees are responsible for matters, including tax matters, arising for the trustee and the beneficiaries.

Often, and understandably, accountants may seek advice of a lawyer in relation to a trust. When the lawyer is given this type of instruction, the natural response is to limit the area of advice. Their liability may nonetheless not be so restricted. In *Austrust Pty Ltd v Astley* (1996) 67 SASR 207<sup>7</sup> a highly experienced commercial lawyer who thought he was simply instructed to give advice on a draft trust deed and compliance with corporations law – and where the client had its own in-house lawyer – was held liable for not advising his client that a trustee has personal liability for the trust’s debts and that his personal liability could have been limited or excluded in various ways, even where that subsidiary issue only arose because the trustee separately asked the lawyer to give advice about contemplated transactions.

An accountant who goes beyond merely preparing returns and provides low-level general advice is in the same position as a lawyer in *Austrust Pty Ltd v Astley*. In *Bell v Vahexi Pty Ltd* (1998) 40 ATR 459 the Court of Appeal of the NSW Supreme Court upheld a finding that a small firm of accountants and tax agents, that limited its practice to compliance work and did not hold itself out as consultants, was negligent in not advising a client about the introduction of the thin capitalisation rules and the simple procedure of issuing new shares to meet the debt to equity ratio because the accountant knew the client paid interest to overseas creditors and thus should have known that the rules might have applied.

In a trust specific context, a bald unqualified statement by an accountant that a trust’s past losses can be carried forward, made without conducting a “due diligence” examination of the circumstances in which those losses arose, will fail to ‘*meet the standard of a prudent and reasonable tax advisor*’: *Leda Pty Ltd Weerden* [2006] NSWSC 125 at [59] per Gzell J.

Further, in *Carmody v Priestley & Morris Perth Pty Ltd* [2005] WASC 120 an accountant was held to be negligent where he failed to advise about the operation of Division 7A of Part III of the 1936 Act when his client told him that his company group was purchasing a property. At [191] Hasluck J held that ‘*the duty of care imposed upon [the accountant] under and by virtue of the ongoing contractual relationship between the parties and at common law required him to offer advice at his own instigation that there was a significant reason why the proposed transaction should not be proceeded with.*’

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<sup>7</sup> This matter went on appeal to the High Court (in *Astley v Austrust Pty Ltd*. (1999) 197 CLR 1) but on a different issue, namely the lawyer’s defence that the plaintiff trustee company’s contributory negligence limited his liability for actions in tort and breach of contract.

These considerations lead to the conclusion that any professionals advising on trusts cannot merely effect distributions mechanically without a proper consideration of the trust law and tax law issues arising therefrom. If time or budgetary constraints impact on the ability to consider those issues the advisor does so at their own peril.

## 2 Interests of a Beneficiary

### 2.1 The Nature of the Interest

In *DKLR Holding Co (No. 2) Pty Ltd v Commissioner of Stamp Duties* [1980] 1 NSWLR 510 at 518 to 521 Hope JA set out the nature of a beneficiary's interest. Although lengthy it bears repeating in full (footnotes omitted):

[14] [After discussing the origin of equitable estates and interests] ... After some hesitation, a trust interest in respect of land came to be regarded, not merely as some kind of equitable chose in action, conferring rights enforceable against the trustee, but as an interest in property. The fact that equitable estates were not enforceable against everyone acquiring a legal title to the property did not prevent them from being so regarded; a legal owner of land could lose his estate in, or become unable to enforce his rights in respect of, land in a number of ways. Although there has long been a controversy whether trust interests are true rights in rem ... there can be no doubt that the interest of the *cestui que trust* is an interest in property ...

[15] These essential features of interests arising under private trusts are thus described in Jacobs' *Law of Trusts*, 3<sup>rd</sup> ed, p 109: "...the trustee must be under a personal obligation to deal with the trust property for the benefit of the beneficiaries, and this obligation must be annexed to the trust property. This is the equitable obligation proper. It arises from the very nature of a trust and from the origin of the trust in the separate of the common law and equitable jurisdictions in English legal history. The obligation attaches to the trustees *in personam*, but it is also annexed to the property so that the equitable interest resembles a right *in rem*. It is not sufficient that the trustee should be under a personal obligation to hold the property for the benefit of another, unless that obligation is annexed to the property. Conversely, it is not sufficient that an obligation should be annexed to property unless the trustee is under the personal obligation."

[16] Several consequences follow. Firstly, [sic] an absolute owner in fee simple does not hold two estates, a legal and an equitable estate. He holds only the legal estate, with all the rights and incidents that attach to that estate. If he were to execute a declaration that he held the land in trust for himself absolutely, the declaration would be of no effect; it would give him no separate equitable rights; he would remain the legal owner with all the rights that a legal owner has. At least where co-extensive and commensurate legal and equitable interests are concerned, "... a man cannot be a trustee for himself.": *Goodright v Wells*, per Lord Mansfield. "You cannot have a legal estate in trust for yourself.": *Harmood v Oglander*, per Lord Eldon. Secondly, although the equitable estate is an

interest in property, its essential character still bears the stamp which its origin placed upon it. Where the trustee is the owner of the legal fee simple, the right of the beneficiary, although annexed to the land, is a right to compel the legal owner to hold and use the rights which the law gives him in accordance with the obligations which equity has imposed upon him. The trustee, in such a case, has at law all the rights of the absolute owner in fee simple, but he is not free to use those rights for his own benefit in the way he could if no trust existed. Equitable obligations require him to use them in some particular way for the benefit of other persons ...

[18] This position can be analysed in a similar way in respect of all rights given to a trustee who holds property at law in trust absolutely for a beneficiary. In some cases the rights vested in the trustee may be such that he cannot be compelled to allow the beneficiary to exercise it except (unless, because of the nature of the right, it is not permissible to do so) in his, the trustee's, name. If this analysis be correct, although the beneficiary has an interest in the trust property, the content of that interest is essentially a right to compel the trustee to hold and use his legal rights in accordance with the terms of the trust. Where the trustee holds absolutely for the beneficiary, the beneficiary has a right in equity to be put, so far as practicable and generally subject to appropriate indemnities being given, into a position where directly, or indirectly, or for all practical purposes, he enjoys or exercises the rights which the law has vested in the trustee ...

[20] What then is the result of the actions of the plaintiff [B, the putative trustee] and of 29 Macquarie [A, the registered proprietor], and of the instruments executed by them; or, rather, what will their effect be when the transfer has been registered? Before the passing of the resolutions and the execution of the instruments, 29 Macquarie was the registered proprietor of the land for an estate in fee simple. It can, no doubt, be said that it was the beneficial owner of that land, but it held no separate equitable interest in the land; the statement means merely that it was the legal owner, and there was no equitable right in anyone to regulate or control the way in which it might exercise the rights which the legal ownership gave to it. The passing of the resolutions and the execution of the instruments, have not yet changed that position. When the transfer is registered, the plaintiff will undoubtedly be the registered proprietor of the land for an estate in fee simple, and will have, at law, all the rights and powers in respect of the land which the ownership of the fee simple will give. However, consequent upon its becoming entitled to these rights and powers, there will be created, at the same time as it become so entitled, an equitable estate in the land in 29 Macquarie, an estate which will entitle 29 Macquarie to require the plaintiff to hold and exercise its rights and powers, so far as practicable, as 29 Macquarie shall direct. Although it may not matter, the interest so arising in 29 Macquarie will not flow from the simple circumstance that the transfer was made without valuable consideration; it will arise (so far as it appears in the state case) because of the intention of the parties evidenced by the resolutions and the declaration of trust. The interest will arise only because the rights and powers which were previously vested in 29 Macquarie have been transferred to the plaintiff. It would not have been possible for 29 Macquarie to have acquired its equitable interest by some kind of exception from the transfer of the legal title. In a loose or popular sense, it may be said that 29 Macquarie transferred a bare legal title to the plaintiff and retained for itself the beneficial ownership, but that is not a correct description of what the memorandum of transfer, and the resolutions and declarations of trust achieved. They achieved a transfer of the estate in fee simple and, thereupon, the create of an equitable state in 29 Macquarie.

From Hope JA, whose observations have been approved,<sup>8</sup> we may observe two important things:

- (a) the content of a beneficiary's interest is a right to compel the trustee to adhere to the terms of the trust.
- (b) a beneficiary's interest is engrafted onto, or imposed on, the holder of the legal title; it is not carved out of the legal estate.

In *CPT Custodian Pty Ltd v Commissioner of State Revenue (Vic)* (2005) 224 CLR 98 the High Court confirmed that the nature of the beneficiary's interest is shaped by the terms of the trust in question. Again the deed is all important.

## 2.2 The Trustee's Right of Indemnity

However, the beneficiary's interest is subject to the trustee's right of indemnity out of trust assets (which applies unless excluded). If an indemnity applies the beneficiary's interest in the trust assets is qualified or deferred because the beneficiary cannot assert a right to compel the trustee to adhere to the terms of the trust to hold the property on the beneficiary's behalf without allowing for that indemnity. In *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 367 the majority said (citations omitted) that a trustee:

... is entitled to be indemnified against [liabilities incurred in discharge of the trust] from the trust assets held by him and for the purpose of enforcing the indemnity the trustee possesses a charge or right of lien over those assets ... the charge is not capable of differential application to certain only of those assets. It applies to the whole range of trust assets in the trustee's possession except for those assets, if any, which under the terms of the trust deed the trustee is not authorised to use for the purposes of carrying on the business. ...

In such a case there are two classes of persons having a beneficial interest in the trust assets: first, the *cestuis que trust*, those for whose benefit the business was being carried on; and secondly, the trustee in respect of his right to be indemnified out of the trust assets against personal liabilities incurred in the performance of the trust. The latter interest will be preferred to the former, so that the *cestuis que trust* are not entitled to call for a distribution of trust assets which are subject to a charge in favour of the trustee until the charge has been satisfied.

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<sup>8</sup> See *Re Transphere Pty Ltd* (1986) 6 NSWLR 309 per McLelland J and *Commissioner of Taxation v Linter Textiles Australia Ltd (in liq)* (2005) 220 CLR 592 at 606.

The High Court subsequently refined the nature of a trustee's right in indemnity, confirming the right is not in the nature of an encumbrance, in *Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226 at 264, saying:

[48] Until the right to reimbursement or exoneration has been satisfied, 'it is impossible to say what the trust fund is.' [*Dodds v Tuke* (1884) 25 Ch D 617 at 619] The entitlement of the beneficiaries in respect of the assets held by the trustee which constitutes the 'property' to which the beneficiaries are entitled in equity is to be distinguished from the assets themselves. The entitlement of the beneficiaries is confined to so much of those assets as is available after the liabilities in question have been discharged or provision has been made for them. [*Kemtron Industries Pty Ltd v Commissioner of Stamp Duties (Q)* [1984] 1 Qd R 576 at 587] To the extent that the assets held by the trustee are subject to their application to reimburse or exonerate the trustee, they are not 'trust assets' or 'trust property' in the sense that they are held solely upon trusts imposing fiduciary duties which bind the trustee in favour of the beneficiaries. [*Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 370].

It seems, therefore, that the trustee's right of indemnity is a right in the nature of a lien or charge, but that is only to enable a court of equitable jurisdiction to authorise the sale or conversation of those assets to satisfy the trustee's right of reimbursement or exoneration.

The right can be enforced even if there has been a change of trustee: *Lemery Holdings Pty Ltd v Reliance Financial Services Pty Ltd* [2008] NSWSC 1344.

### **3 Desirable Provisions in a Modern Trust Deed**

Although not an exhaustive list the following specific provisions that arise in relation to discretionary trusts from changes or evolutions in the tax law, trust law and current practice.

#### **3.1 Annual Deadline for Income Distributions**

Prior to *Bamford v Commissioner of Taxation* (2010) 240 CLR 481 the Commissioner of Taxation allowed a grace period of two months following the end of a financial year for trustees to pass resolutions distributing trust income: *Taxation Rulings* IT 328 and IT 329. These were administrative concessions only and did not override the obligations at law or in the governing trust deed.

However, following the decision in *Colonial First State Investments Ltd v Commissioner of Taxation* [2011] FCA 16 the Commissioner of Taxation indicated that a beneficiary could not be

“presently entitled” to a share of the trust’s distributable income unless the resolution to distribute was made on or before 30 June. Those two rulings have now been withdrawn.

This tax obligation for a 30 June deadline does not impose such an obligation to have that deadline in the deed. Doing so can lead to later problems. For example, if a dispute arises between beneficiaries and the trustee the trustee may have difficulty establish the validity of prior year distributions if it cannot prove their being made on or before a particular 30 June. Not including a 30 June (or other) deadline removes this problem.

Where no deadline is inserted a later resolution may not be valid for tax purposes but it will be valid for trust law purposes. This was confirmed in *BRK (Bris) Pty Ltd v FCT* 2001 ATC 4111 where the court held that the trustee has ‘a reasonable time within which to decide’ how to distribute income where there was no 30 June requirement in the deed.

### **3.2 Trustee’s Discretion to Determine Net Income**

Since *Bamford v Commissioner of Taxation* (2010) 240 CLR 481 it is settled that a trustee can have the power to determine what amounts will be regarded as being received or paid on revenue or on capital account for the purposes of determining the “distributable income” of the trust. This basis does not, necessarily, need to be consistent with tax or accounting principles, though of course it can be.

A trustee with this discretion has significant flexibility, being one of the main benefits of using a discretionary trust. For instance, in *Clark v Inglis* [2010] NSWCA 144 (discussed in more detail at paragraph 7.3 below) resulted in changes in the share price, on shares that were not sold, being income of the trust.

But this discretion only exists if the trust deed permits it. Having the correct drafting is therefore critical. Absent these provisions the distributable income will be determined in accordance with ordinary trust law principles. Further, if the trust deed fixes a definition of income the trustee has no discretion to ignore that prescription.

Good drafting therefore suggests:

- (a) a definition of trust income should be included so that trust law principles do not automatically apply;

- (b) the trust deed should give the trustee discretion to adopt an alternative concept of income where the trustee considers it appropriate;
- (c) the trust deed should include a general power allowing the trustee to determine what amounts are received or paid on capital or on revenue account each year.

How a distribution resolution is prepared then becomes critical: see paragraph 4 below.

### **3.3 Allowing Distributions from Gross Income to Preserve Franking Credits**

A beneficiary cannot claim the benefit of any imputation credits attaching to a franked dividend beyond the beneficiary's proportionate entitlement to a share of the trust's net income under s 97 of the *Income Tax Assessment Act* 1936 (Cth) (the '**1936 Act**'). The difference between the income of the trust, and the "net income" for s 95 of the 1936 Act purposes, is important: see Kitto J in *Union Fidelity Trustee Co of Australia Ltd v FCT* (1969) 119 CLR 177.

Present entitlement is not defined in the legislation; it is resolved via the case law, which establish that present entitlement arises where a beneficiary has an indefeasible and vested interest (vested in interest and in possession) upon which they can immediately call.

A difficulty arises where the trust estate has positive "net income" – for instance because of a capital gain or franking credits – but where there is no income according to trust law. The Commissioner of Taxation considers the absence of income available for distribution in a year then there is no amount to which a beneficiary can be presently entitled under s 97 of the 1936 Act: *Taxation Ruling* 1992/3 at [17].

Therefore, if the trustee has a power to make distributions out of the gross income (before calculating the distributable net income) arguably the beneficiaries are entitled to a share of the trust income under s 97 of the 1936 Act and the beneficiary would be required to include the same property of the "net income" under s 95 of that Act in their assessable income.

### **3.4 Excluding Notional Amounts of Income**

A common approach has been to equate trust income with "net income" as defined in s 95 of the 1936 Act. The risk in this approach is that the net income determined under the 1936 Act includes notional amounts such as franking credits and deemed dividends under Division 7A of Part III of the 1936 Act. These amounts are not represented by actual receipts the trustee receives.

A definition should therefore be available that removes from “net income” for s 95 of the 1936 Act purposes the notional amounts. Importantly this should not be prescriptive it should also allow the trustee a discretion.

For completeness I note the Commissioner of Taxation considers that notional amounts cannot be taken into account in calculating the “distributable income” of the trust: *Taxation Ruling* 2012/D1 at [15]. This reduces the ability to manipulate the proportionate approach to net income. On this issue see the Queensland Supreme Court’s decision in *Thomas Nominees Pty Ltd v Thomas* [2010] QSC 417 and the Federal Court’s decision in *Thomas v Commissioner of Taxation* [2015] FCA 968. Both cases related to the same trust but conflicted in their outcome.

### **3.5 Dealing with Unpaid Present Entitlements**

Until 2010 a trust could appoint income to a beneficiary, and thereby making them presently entitled to the income, without actually distributing the income to the beneficiary. The beneficiary would then have an “unpaid present entitlement” on which the beneficiary can call at any time. It was common under these arrangements for the trustee to distribute to the beneficiary enough of the appointed income to cover the tax liability arising on it.

The Commissioner of Taxation was frustrated by this approach as it permitted the after tax amount, based on a corporate beneficiary’s lower tax rate, to be reinvested in the trust and, thereby access the discount capital gains on those reinvested assets. The frustration arose because corporations, who had the lower tax rate, would otherwise not be able to access the discount.

In *Taxation Ruling* 2010/3 the Commissioner of Taxation confirmed that unpaid present entitlements arising after December 2009 will trigger a deemed dividend under Division 7 of Part III of the 1936 Act unless the entitlement is:

- (a) converted into a loan (repayable on the term of Division 7A); or, alternatively
- (b) is placed on a sub-trust with an investment agreement that requires the sub-trust amount to be paid either over a seven or ten year term (depending on the interest rate applied).

Practicalities of this approach are set out in the Commissioner of Taxation’s *Practice Statement Law Administration* 2010/4, which provides the safe harbours therein require the use of a sub-trust.

Although the Commissioner of Taxation considers a resolution is sufficient to create the sub-trust (see at [52] and [53]) the safer course is to include the ability of the trustee to hold on sub-trust in the deed.

### **3.6 Specific Entitlement to Future Capital Gains**

There is an ability to treat capital gains and franking credits via relatively recent amendments to the income tax legislation: see paragraph 5 below. It is here convenient to note a drafting tool to address a problem in the capital gains streaming provisions.

A condition for streaming a capital gain to a particular beneficiary is that the beneficiary must be “specifically entitled” to the gain by 31 August following the end of the financial year in which the gain arises: ss 115-228 and 207-58 of the 1997 Act. Difficulty arises because the gain may arise in a year that the contract is exchanged (see for CGT Event A1) but the trustee may receive the receipt of sale proceeds, and the specific entitlement to them may be crystallised in the beneficiary, much later. For example, the earn out provisions introduced by *Tax and Superannuation Laws Amendment (2015 Measures No. 6) Act*.

It becomes important to give the trustee power to make a beneficiary specifically entitled to a gain that may not be receive, or otherwise be crysitalised, for some years after the resolution is made. Most trust deeds do not contain this sort of provision.

### **3.7 Asset Revaluation Reserves**

This is a significant power of a trustee. It is considered separately at paragraph 7 below.

### **3.8 Streaming Provisions**

This is a significant power of a trustee. It is considered separately at paragraph 5 below.

### **3.9 Breaches of a Family Trust Election**

Details of the Family Trust Election and an Interposed Entity Election are set out in detail at paragraph 9 below. Dealing with the consequences of a breaching those elections is important and considered here.

The two elections do not prohibit the distribution outside of the delineated group; they merely make the tax cost of doing so prohibitive. “Family trust distribution tax” is imposed at the top

marginal rate. That amount is then excluded from the recipient's assessable income (to avoid double counting): s 271-15 of Schedule F to the 1936 Act.

At trust law, however, the beneficiary can call for the distribution, which is not reduced by the amount of family trust distribution tax paid by the trustee. The trustee will be liable to pay 149.5% of the appointed amount: 100% to the beneficiary and 49.5% to the Commissioner of Taxation.

This problem compounds if the tainted distribution is to a corporate beneficiary because it will remain an unpaid present entitlement, with possible Division 7A consequences, and if that corporate beneficiary pays a distribution to its shareholders the dividend is unfrankable, so the shareholders pay tax again.

To address this the trust deed may provide that any distribution that would otherwise trigger family trust distributions tax is invalid.

### **3.10 Accessing the Small Business Concessions**

Given the prevalence of trustees of discretionary trusts conducting businesses they're ability to access the small business concessions in Division 152 of the *Income Tax Assessment Act 1997* (Cth) (the '**1997 Act**'). They include the 15 year exemption (Subdivision 152-B), the active asset discount (Subdivision 152-C), the retirement exemption (Subdivision 152-D) and the rollover relief (Subdivision 152-E).

There are also basic conditions in Subdivision 152-A. These require the payments to be made to individuals who qualify as "CGT concession stakeholders". If they qualify the amounts are excluded as assessable income of the trust and they are non-assessable amounts in the beneficiary's hands. Not many trust deeds have any express provision giving the trustee the power to make such a payment. Generally, most trust deeds limit the distributions of trust income or capital, which may not include these amounts.

It is therefore good drafting to include a specific power in trust deeds allowing the trustee to make payments to "CGT concession stakeholders" irrespective of whether they are beneficiaries of the trust.

### 3.11 The Trustee's as a Beneficiary

Clients may sometimes want to make distributions to a trustee. If they do you must confirm that the trustee can benefit under the deed. Some deeds exclude the trustee from benefiting. This will most commonly arise where there has been a change of trustee as the \$50 concessional duty only applies to dutiable transactions arising from a change of trustee where new and ongoing trustees are unable to benefit under the trust: s 54(3) of the *Duties Act 1997* (NSW).

Given there is usually little commercial imperative to include the trustee as a beneficiary – and that having a corporate trustee which limits its function to acting as trustee reduces the exposure of trust assets to outside claims – there is often little pressing need to have the trustee benefit under a trust.

### 3.12 Distributions to other Trusts: Perpetuity & Character of Receipt

This is a significant power of a trustee. It is considered separately at paragraph 8 below.

## 4 Effecting Distributions

This section of the paper addresses issues to be considered when making a decision regarding the distribution of the income of a discretionary trust for an income year and when carrying out that decision.

When the trustee of a discretionary trust is considering the making of a distribution in any year from that ending 30 June 2011, a number of issues arise by reason of the *Tax Laws Amendment (2011 Measures No. 5) Act 2011* (Cth). In particular they include streaming of capital gains and franked distributions. They will be addressed at heading 5 below.

### 4.1 A Proposed Checklist

A trustee with discretion to distribute may find the following checklist helpful in undertaking the process of determining how to distribute:

Item	Issues to be Addressed
1	Does the trust deed require the trustee's decision to be effected by a particular time and, if so, what is that time?

2	Does the trust deed require the consent or approval of some person (e.g. appointor, protector or guardian of the trust), either generally or in a particular circumstance?
3	Have any distributions already been made in the current income year? If so, they should be taken into account in the final decision of that year.
4	Does the nature of the trust (e.g. testamentary, child maintenance or superannuation proceeds trusts) require particular considerations to be undertaken?
5	Who are the entities to whom a distribution can be made?
6	Do any particular considerations apply to categories of entities within the class at step 5? (e.g. minors, companies, other trusts)
7	Is the trust a family trust or has an interposed entity election been made? (see heading 9 below in this regard)
8	Are there any special income tax or CGT considerations that would render a particular distribution proper or improper? (e.g. small business CGT concessions or the trust loss rules, and in particular the pattern of distribution test)
9	Does the trust deed permit the accumulation of income? If so, do the present circumstances warrant such an accumulation?
10	What amounts has the trustee derived in the current income year and what are the trustee's outgoings or liabilities?
11	Does the trust deed define the income of the trust for a income year?
12	Does the trust deed permit characterisation of income or capital gains? If so, what steps or administrative procedures must be followed to so characterise a particular amount?
13	Will the "net income" exceed the trust income for the income year? If so, what consequences follow and should any action be taken under the trust deed?
14	If the trustee's income for a income year is a negative amount, can anything be done under the deed to avoid the trustee being assessed on a positive "net income" amount?
15	What are the sources of income for the income year and is it desirable to stream any of them to particular beneficiaries?
16	If a distribution is to be made to an exempt entity the anti-avoidance rules should be considered.
17	If an asset is to be distributed in specie, it should be confirmed that the trust deed allows this and what, if any, CGT or GST consequences should be considered.
18	The trustee should confirm it is compliant with its obligations under the TFN withholding rules.

The more significant issues in effecting a distribution will now be discussed.

#### **4.2 Time of Decision**

A decision or resolution by a trustee with discretion to distribute the income of a trust for an income year will only be effective if it is effected by the *earlier* of:

- (a) the end of the last day of the income year (being 30 June in the case of a standard accounting period); or
- (b) the time prescribed in the trust deed for making the distribution.

Before the income year ending 30 June 2011 the Commissioner of Taxation had adopted an administrative practice which allowed a trustee two months after the close of an income year within which to make a distribution decision or resolution which the Commissioner would accept as effective for that year: *Taxation Rulings* IT 328 and IT 329, both now withdrawn. This administrative practice never addressed the underlying trust law issues of requiring compliance with the deed. Further, the Commissioner could always have departed from the practice in a particular case: cf *Patcorp Investments Ltd v FCT* [1967] HCA 67.

That practice arose in recognition of the fact a trustee may not be able to determine a trust's income and expenses for a given year until sometime after that year ends. The current position suggests resolutions that provide for exact amounts are not to be preferred; rather, a decision or resolution should state percentages to beneficiaries or provide for fixed amounts with the balance of any income so determined to go to a particular beneficiary.

Though as to a two year period following the end of an income year, see the streaming amendments such as s 115-228(1)(c) of the 1997 Act.

#### **4.3 Means of Making the Decision or Resolution**

Some discretionary trust deeds are silent on the way the trustee may make a distribution resolution or determination, while others specify the procedure that may be adopted. If the trust deed is silent on the issue and the trustee is a:

- (a) person, it may be determined by the person merely making the decision. However, for evidentiary purposes a written record is advised to be created, and preferably a written resolution of the determination; and
- (b) company a resolution or determination of the directors must be made in accordance with its constituent documents (be it a *Constitution* or the *Memorandum and Articles of Association*).

It is now clear that the crediting of trust accounts is sufficient to have resolved or determined to apply that income to a particular beneficiary, whether because the trust deed says so (*Chianti Pty Ltd v Leume Pty Ltd* (2007) 35 WAR 488) or it does not: *In Re Baron Vestey's Settlement; Lloyd's Bank Ltd v O'Meara* [1951] Ch 209 cited in *Fischer v Nemeske Pty Ltd* [2015] NSWCA 6 at [59].

#### **4.4 Trustee's Duty in a Discretionary Power**

How a trustee may exercise their discretion to appoint or distribute income of the trust is an important consideration, including what reasoning, if any, is to be given. As will be seen, to provide reasons invites review.

The concept of "discretion" involves making a choice from a number of available alternatives, amongst which the decision-maker is free to choose.

##### **4.4.1 Can the trustee's decision be reviewed?**

The often quoted passage of McGarvie J in *Karger v Paul* [1984] VR 161 at 163-164 has resulted, in practice, in many trustees, especially of what are called "family discretionary trusts" not giving reasons for many decisions. His Honour there said:

The discretionary power given to the trustees by cl 3, was a power, upon the request of Mr Smith, in their absolute and unfettered discretion to pay or transfer the whole or part of the capital of the estate to him. 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.

There are two points to note about this passage. First, it relates to a discretion “in these terms” – that is, it is dealing with a particular trust instrument. A peculiarity of the terms of the relevant clause was that the trustees had power to transfer to one of them; at least in relation to that one any fiduciary duty not to derive a personal advantage from exercise of the power must have been impliedly negated by the terms of the gift. Further, the power was described in these terms ‘absolute and unfettered discretion’. Secondly, the allegation in the case was that the breaches consisted of not acting in good faith and not acting upon a fair and proper consideration. Thus, McGarvie’s J statement as to some different allegation than what was actually made in the case would be *obiter dictum*.

These points of note, themselves, show the broadness (if taken out of context) of the above statement may not be appropriate. There are also other decisions that establish a trustee’s exercise of discretion is in no way immune to review or alteration.

In *Parkes Management Ltd v Perpetual Trustee Co Ltd* (1977) 3 ACLR 303 at 311 Hope JA (with whom Moffit P agreed) held:

In equity, where a trustee has a discretionary power, that power “must be exercised with an absence of indirect motive, with honesty of intention and with a fair consideration of the issues”: Jacobs Law of Trusts, 4<sup>th</sup> ed p 301. In Lewin on Trusts 15<sup>th</sup> ed p 32, the requirement is expressed to be that the trustee’s conduct be bona fide and the determination not influenced by improper motives. There is ample authority for these propositions.

Chief Justice Barwick, in *Lutheran Church of Australia South Australian District Inc v Farmers’ Co-operative Executor & Trustees Ltd* (1970) 121 CLR 628 at 639, said of a mere power conferred on a trustee:

... whilst the power is not in the nature of a trust so that the trustee must exercise it, equity would ensure that the trustee bona fide considers whether or not the power should be exercised, and that in doing so, proper considerations are in mind, and improper considerations excluded. The discretionary nature of the power does not mean that the discretion is absolute, in the sense that it can be exercised irresponsibly, capriciously or wantonly.

Another formulation of when an exercise of a discretionary power can be held ineffective is if the trustees act for reasons that are ‘irrational, perverse, or irrelevant to any sensible expectation of the settlor.’: *Re Manisty’s Settlement* [1974] Ch 17 at 26. Other cases have also highlighted

what constitutes a valid exercise of a discretionary power – for instance, there being a duty for the donee of the power to exercise it in person and not under the dictation of someone else, and a duty not to fetter the exercise of a discretion.

In the context of a superannuation fund, Heerey J, in the Full Court of the Federal Court, in *Wilkinson v Clerical Administrative & Related Employees Superannuation Pty Ltd* (1998) 79 FCR 469 at 480 quoted a statement of Northrop J in the court below concerning the grounds on which an exercise of a trustee's power could be challenged in a court:<sup>9</sup>

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 settler, 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.

The joint decision of Gleeson CJ, McHugh, Gummow, Hayne and Callinan JJ in *Attorney-General (Cth) v Breckler* (1999) 197 CLR 83 suggests their Honours approved of the above quote.

These cases show that the exercise of a trustee will be subject of review and how they will be reviewed.

#### **4.4.2 The Karger v Paul Test**

The first task of a the court in deciding whether a trustee has exercised a discretion or formed an opinion appropriately is to turn to the trust documents. Careful attention must be paid to the exact discretion that is under review. If the trustee has not considered the correct question, the decision is not the type of decision that the trust deed empowers the trustee to make, and so it is not an effective exercise of power. If the correct question(s) was asked by the trustee the court then reviews the way the trustee answered the question.

The court can be assisted in deciding whether a trustee has complied with the *Karger v Paul* requirements for the exercise of a discretion or formation of opinion by examining the material on the basis of which the trustees have made their decision. If on that material trustees acting

<sup>9</sup> Citations in the quote itself are removed.

honestly and reasonably could not have come to the conclusion to which the trustee actually came, the decision is invalid. Justice Bryson said it thus in *Sayseng v Kellogg Superannuation Pty Ltd* [2003] NSWSC 945 at [63]:

... if the Trustee came to a conclusion which no reasonable person could have come to one of the first three grounds of challenge referred to in *Rapa v Patience* must be available; an unreasonable conclusion cannot be reached without either a failure to exercise power in good faith, or a failure to exercise the power upon real and genuine consideration, or a failure to exercise the power in accordance with the purposes for which it was conferred.

In finding that the decision is invalid the court need not identify precisely which of the first three grounds of challenge has been breached; it is sufficient to decide that one or other of them must have been breached. Such a process of reasoning is one that had been used by the High Court. In *Elders Trustee & Executor Co Ltd v Higgins* (1965) 113 CLR 426 at 451-452 Dixon CJ, McTiernan and Windeyer JJ said:

the appellant has asked us to infer that, since mala fides or neglect is not to be imputed to a trustee from his silence alone, the various possibilities must have all been considered and a decision made to reject them. If that were so, the decision would seem to have been one that a prudent man, duly considering the relevant facts, could not reasonably reach.

The message to take from these cases would appear to be a trustee's exercise of a discretion:

- (a) is not immune to challenge – the usual principles of a fiduciary nature will impose restricting constraints and require the trustee to properly conduct the trust; but
- (b) it need not be the subject of recorded reasoning as to do so invites an easier critique than would otherwise be the case.

The benefit a trustee obtains by not recording reasons is also not lost because a beneficiary applies to a court for production of documents or the provision of information in relation to the decision or determination that was made: *Mandie v Memart Nominees Pty Ltd* [2014] VSC 290.

## 5 Streaming

Where a trust estate has a net capital gain, a franked distribution or a franking credit for an income year, the position before the income year ending 30 June 2011 was that these amounts were brought into the calculation of the net income (s 95 of the 1936 Act) of the trust estate for the income year and that net income was attributed to the beneficiaries proportionately according to the presently entitled share of the trust income of the trust estate. That is no longer the position.

### 5.1 Capital Gains

Where a trust estate has a net capital gain in the income year ending 30 June 2011 or later, the *Tax Laws Amendment (2011 Measures No. 5) Act 2011* (Cth) applies. In very broad terms, where a trust estate has a net capital gain and ‘net income’ for an income year, a capital gain that is not reduced to nil by the application of the method statement in s 102-5 of the 1997 Act<sup>10</sup> is taken out of the operation of Division 6 of Part III of the 1936 Act: Division 6E of that Part. Instead, its treatment is governed by the provisions of Division 115 of the 1997 Act, and in particular Subdivision 115-C of that Act.

The position is that:

- (a) to the extent to which a beneficiary is ‘specifically entitled’ to an amount of the capital gain (before applying the method statement), an appropriate part of the gain (after applying the method statement) is attributed to the beneficiary as a capital gain.
- (b) to the extent to which there is no beneficiary ‘specifically entitled’ to an amount of the capital gain (before applying the method statement), beneficiaries have an appropriate part of the gain (after applying the method statement) attributed to them on a pro rata basis according to their share of the distributable income of the trust estate. If there is no distributable income of the trust estate for that income year (or there is part of the distributable income to which no beneficiary is presently entitled), the trustee is taxed on the amount of the capital gain (or the appropriate part of the capital gain) after applying the method statement.
- (c) where the trust estate was entitled to the CGT discount capital gain concession (Division 115 of the 1997 Act) and or the CGT small business active asset reduction (Division 152

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<sup>10</sup> That is, but offsetting any capital losses and net capital losses and applying any relevant CGT concessions.

of the 1997 Act), a beneficiary's (or the trustee's) attributed capital gain is grossed up appropriately.

- (d) a beneficiary's attributed capital gain (grossed up if necessary) is taken into account in the calculation of the net capital gain (or loss) of the beneficiary. When calculating the net capital gain, the beneficiary may apply the CGT discount capital gain concession and the CGT small business concessions to which the trust estate was entitled.

This regime speaks of a beneficiary being 'specifically entitled'. Section 115-228 of the 1997 Act provides:

### **Specifically entitled to an amount of a capital gain**

- (1) A beneficiary of a trust estate is *specifically entitled* to an amount of a \* capital gain made by the trust estate in an income year equal to the amount calculated under the following formula:

$$*Capital\ gain \times \frac{Share\ of\ net\ financial\ benefit}{Net\ financial\ benefit}$$

where:

*"net financial benefit "* means an amount equal to the \* financial benefit that is referable to the \* capital gain (after any application by the trustee of losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)).

*"share of net financial benefit "* means an amount equal to the \* financial benefit that, in accordance with the terms of the trust:

- (a) the beneficiary has received, or can be reasonably expected to receive; and
- (b) is referable to the \* capital gain (after application by the trustee of any losses, to the extent that the application is consistent with the application of capital losses against the capital gain in accordance with the method statement in subsection 102-5(1)); and
- (c) is recorded, in its character as referable to the capital gain, in the accounts or records of the trust no later than 2 months after the end of the income year.

Note: A trustee of a trust estate that makes a choice under section 115- 230 is taken to be specifically entitled to a capital gain.

- (2) To avoid doubt, for the purposes of subsection (1), something is done in accordance with the terms of the trust if it is done in accordance with:

- (a) the exercise of a power conferred by the terms of the trust; or
  - (b) the terms of the trust deed (if any), and the terms applicable to the trust because of the operation of legislation, the common law or the rules of equity.
- (3) For the purposes of this section, in calculating the amount of the \* capital gain, disregard sections 112-20 and 116-30 (Market value substitution rule) to the extent that those sections have the effect of increasing the amount of the capital gain.

Preferably the trust deed would provide for the trustee to be able to make a beneficiary 'specifically entitled' to an amount of capital.

In order to allow streaming of capital gains, however, the trust deed must give the trustee that power.

The Commissioner of Taxation has determined that it is possible (depending on the circumstances) for a beneficiary of a trust estate to be reasonably expected to receive an amount of a financial benefit referable to a capital gain for the purposes of s 115-228(1) of the 1997 Act, despite the making of the capital gain not being established until after the end of the income year: *Taxation Determination* TD 2012/11.

## 5.2 Franking Credits

Specific streaming provisions for franked distributions received by a trust estate in the income years ending 30 June 2011 or later were made by *Tax Laws Amendment (2011 Measures No. 5) Act 2011* (Cth). Where a trustee with discretion holds shares in a company as an asset of the trust and a franked distribution is made by the company to the trustee, the assessable income of the trust for the income year includes the amount of the franking credit on the distribution in addition to the franked distribution itself: s 207-35(1) of the 1997 Act.<sup>11</sup>

As stated above, as a result of the amendments made by that amending Act, where a trust estate receives a franked distribution, in broad terms, Division 6E of the 1936 Act takes the distribution outside the operation of Division 6 of Part III and renders it subject to Division 207 of the 1997 Act (and in particular Subdivision 207-B thereof).

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<sup>11</sup> For the situation where the trustee is assessable under ss 98, 99 or 99A of the 1936 Act, see s 207-35(5) and (6) of the 1997 Act.

As with the capital gains issues discussed, the way the streaming of a franked distribution, and the associated franking credits, is achieved is by a beneficiary or beneficiaries being made 'specifically entitled' to the franked distribution.

The concept of specific entitlement for these purposes is set out in s 207-58(1) of the 1997 Act, which provides:

**Specifically entitled to an amount of a franked distribution**

- (1) A beneficiary of a trust estate is *specifically entitled* to an amount of a \* franked distribution made to the trust estate in an income year equal to the amount calculated under the following formula:

$$\text{*Franked distribution} \times \frac{\text{Share of net financial benefit}}{\text{Net financial benefit}}$$

where:

*"net financial benefit "* means an amount equal to the \* financial benefit that is referable to the \* franked distribution (after any application by the trustee of expenses that are directly relevant to the franked distribution).

*"share of net financial benefit "* means an amount equal to the \* financial benefit that, in accordance with the terms of the trust:

- (a) the beneficiary has received, or can be reasonably expected to receive; and
  - (b) is referable to the \* franked distribution (after application by the trustee of any expenses that are directly relevant to the franked distribution); and
  - (c) is recorded, in its character as referable to the franked distribution, in the accounts or records of the trust no later than the end of the income year.
- (2) To avoid doubt, for the purposes of subsection (1), something is done in accordance with the terms of the trust if it is done in accordance with:
- (a) the exercise of a power conferred by the terms of the trust; or
  - (b) the terms of the trust deed (if any), and the terms applicable to the trust because of the operation of legislation, the common law or the rules of equity.

Where no beneficiary is specifically entitled to a franked distribution or part of it, the beneficiaries' respective shares of the distribution, and the associated franking credit, are determined by reference to the adjusted Division 6 percentages of the beneficiaries. The starting

point of that percentage is the beneficiary's share in the trust estate's net income for that income year.

There can be no streaming of franked distributions where:

- (a) the trust deed does not confer an adequate power on the trustee;
- (b) the trust estate does not have a positive 'net income' for the income year; or
- (c) expenses that are directly relevant to the franked distribution exceed the franked distribution,

and it is not possible to stream a franking credit independent of the franked distribution to which it attaches.

### **5.3 Absence of streaming provision**

If the trust deed contains no provision which would allow the streaming of categories of income (for example, foreign sourced income) and, having regard to the Commissioner of Taxation's view on streaming following *FCT v Bamford* [2010] HCA 10, it would seem that the Commissioner would not regard the streaming of any category of income or capital gains (other than capital gains and franked distributions in accordance with the statutory provisions) as being effective for tax purposes. The Commissioner's interpretation of *FCT v Bamford* was confirmed in *FCT v Greenhatch* [2012] FCAFC 84.

### **5.4 Terms to be Provided for in a Trust Document**

Given the changes in the taxation of trusts, it is recommended that trust deed (or any other constituent documents) be reviewed so as to determine:

- (a) How income, capital gains and outgoings are accounted for and determined; and
- (b) How income, capital gains and outgoings are to be distributed.

Some of the powers which may be advantageous to have within a trust instrument include:

- (a) an accounting policy which is sufficiently broad and allows the trustee to exercise maximum discretion;
- (b) the discretion to reclassify and allocate income and capital gains;
- (c) the discretion to reclassify and allocate outgoings;

- (d) the discretion not to recoup losses (whether income or capital in nature);
- (e) the ability to allocate and stream classes of income and capital and their related tax attributes;
- (f) ensure that any unpaid present entitlement / loan provisions are removed, and an ability to hold amounts subject to a sub-trust.

Some additional powers to be considered include:

- (a) whether the trustee has the power to distribute income and / or capital at any time within a tax year;
- (b) whether any determination of income (or capital) can be made within the income tax year; and
- (c) whether the trustee has a power to determine entitlements with respect to an income tax year after the relevant year.

#### ***5.4.1 Accounting policy***

Essential is ensuring that the trust deed provides guidance with respect to an accounting policy that should be used by the trustee. Such an accounting policy should provide sufficient flexibility for the trustee, so that it may depart from generally accepted accounting standards in the event that the trustee considers that it is appropriate to do so.

#### ***5.4.2 Reclassifying and allocating income and capital***

As the High Court in *FCT v Bamford* accepted that the tax law income of a trust is dependent upon (amongst other things) the definition of that term in the trust deed, regard should be given to the definition of the 'income' as contained in the trusts constituent documents.

An issue to consider is whether attributed amounts (e.g. franking credits) should be included within the definition of trust income. An issue that arises is that if attributions are included in trust income (and which are not physically 'paid' by a trustee – but which follow certain amounts of income), whether by being included in trust income, and thereby providing that a trustee creates a 'present entitlement' in a beneficiary to an amount that is never received by a trustee, the trustee will be exposed to a claim in relation to amounts that are not actually received by the trustee.

It is submitted that amounts such as franking credits should be prima facie carved-out of the definition of income. However, the definition should contain discretionary elements to allow a trustee to cause such ‘attributed’ amounts to fall within the definition of income.

An approach which may be considered is, in defining trust income:

- (a) Provide that it prima facie equals the amount provided for in s 95(1) of the 1936 Act (less any franking credits);
- (b) If the tax law approach is not warranted for a particular tax period, then:
  - (i) According to an accounting policy adopted by the trustee; or
  - (ii) Any other basis as determined by the trustee; or
- (c) In the trustee’s absolute discretion, the gross income of the trust.

#### **5.4.3 *Reclassifying and allocating outgoings***

In *Cajkusic v FC of T (No 2)* [2006] ATC 4752 deductions allowable to a family discretionary trust for payments that were made under an employee benefits trust arrangement in the income tax years ending 30 June 1997 and 30 June 1998 caused there to be a loss within the trust estate.

As a result of the losses, there was no distributable income of the trust. As a result, the Full Court of the Federal Court held that the lack of distributable income meant that there could be no beneficiary of the trust (for the relevant income tax years) to be “... *presently entitled* ...” pursuant to s 97 of the 1936 Act to any amount.

It should be noted that the Commissioner’s subsequent application for special leave to appeal to the High Court was rejected.

*Cajkusic v FC of T (No 2)* stands for the proposition that the ‘distributable income’ of a trust is determined by reference to proper accounting principles, as well as the terms of a trust deed. In this context distributable income is income determined according to accounting principles, and which is distributable amongst the beneficiaries. It does not alter either the income as calculated under accounting principles, of the ‘net income’ as determined under s 95(1) of the 1936 Act – rather, only gives a trustee the power to determine the distributable amounts.

As a result of the decision in *Cajkusic*, it is submitted that a trust deed should give a trustee the power to reclassify, and allocate outgoings, so that there can be ‘distributable income’ to which beneficiaries are presently entitled.

#### 5.4.4 *Discretion not to recoup losses (whether income or capital in nature)*

It is recommended that a trustee have a discretion not to recoup losses (whether of an income or capital nature). That is, a power not to recoup losses which have arisen in the past.

## 6 CGT Event E4

If the relevant trust is a unit trust, no distribution issues are conclusive dealt with until CGT Event E4 is confirmed as applying or not applying. It is convenient to consider the event itself and then strategies to deal with it.

### 6.1 CGT Event E4

CGT Event E4 event happens if the trustee of a trust makes a payment to the taxpayer in respect of that taxpayer's unit or interest in the trust, and some or all of the payment is not assessable: s 104-70 of the 1997 Act.

CGT Event E4 will arise where a unit holder receives a distribution of trust income for an income year which exceeds the trust's net income for that year even where the difference results from an expense being deductible for taxable purposes in that year which was properly charged against income for trust law purposes: *Interpretative Decision* ATO ID 2012/63.

The active asset discount in the Small Business CGT concessions, depreciation deductions or asset revaluation distributions (see heading 7 that follows) are two examples of how non-assessable amounts can be distributed to a unit holder. Importantly, the general discount in Division 115 of the 1997, whilst potentially available on an E4 gain, will not cause CGT Event E4 when amounts so protected are distributed to the unit holders.

CGT Event E4 operates to reduce the unitholder's interest in the units on issue and, when that amount is exhausted, to derive a capital gain. For guidelines on this issue see *Taxation Determination* TD 93/170 and *Taxation Determination* TD 93/171.

CGT Event E4 cannot produce a capital loss. But if the units were acquired before 20 September 1985 the gain is disregarded.

Although the Commissioner of Taxation's pronouncements are unclear, various commentators consider that the general discount in Division 115 of the 1997 Act can apply to a capital gain arising under CGT Event E4. For these reasons I agree with this view:

- (a) The 1997 Act states that the general discount does not apply to CGT Events D1, D2, E9, F1, F2, F5, H2, J2, J5, J6 and K10: s 115-25(3) of the Act. That the 1997 Act expressly excludes some CGT Events implies the others are able to apply the general discount.
- (b) The mechanical application of Division 115 of the 1997 Act, which contains the general discount provisions, suggests it can be applied a capital gain arising from CGT Event E4.

It therefore seems a unitholder could nonetheless apply the general discount to any CGT Event E4 gain.

## **6.2 Strategies to Deal with It**

From the above it can be seen that having a low cost base in the units of a unit trust will more quickly turn a CGT Event E4 from a non-cash issue to a cash issue. That is, whilst there remains cost base in the units to absorb the event no taxing liability arises (the cost base is merely eroded). It is only once the cost base is entirely eroded that a unitholder will be forced to pay a tax liability.

### **6.2.1 First Strategy to Deal with It**

An obvious alternative to this issue is to ensure that any borrowing to fund asset purchases occurs at the unitholder level. That is, debt is used to fund the acquisition of units in the unit trust, which units therefore have a much higher cost base.

In such circumstances, it is highly unlikely that the unit holder's cost base would be reduce to nil as a result of CGT Event E4 occurring, meaning that tax deferred amounts are unlikely to result in a capital gain under CGT Event E4.

To the extent the borrowing costs exceed distributions from the unit trust, such amounts may be used to offset the unit holder's other income. Given the current climate on negative gearing real property this may become a more attractive structure than was previously the case.

### **6.2.2 Second Strategy to Deal with It**

Another alternative to this issue is to:

- (a) have the unitholders subscribe for units in the unit trust equal to the value of the assets to be acquired. The subscription price may be partly paid in the first instance, but they are obliged to pay the balance of the subscription price at a later time.
- (b) the trustee then borrows the remaining amount required to purchase the assets.

As the unit holder's cost base in the units is equal to the amounts paid, or required to be paid (see s 110-25(2)(a) of the 1997 Act), the amount outstanding will be included in the unit holder's cost base even though it need not be paid immediately: s 103-5 of the 1997 Act. As a practical matter the balance of the subscription price would be paid by the unit holders when the underlying assets are sold.

The main issues to consider in this context are, first, and as always, to ensure that the unit trust deed allows this practice, and secondly, that when the assets are sold the amount unpaid on the units is paid by way of set-off against the right to receive the proceeds of the trust property sold. The latter is necessary to ensure that this amount is included in the unit holder's cost base.

## 7 Asset Revaluation Reserves

Although notoriously disliked by the Commissioner of Taxation, strategies to distribute asset revaluation reserves do not seem to be assessable to the recipient. They are a return of capital: the point to be made is that the asset revaluation reserve 'distribution' is in fact a distribution of capital of the trust estate or an advance of the capital of the trust estate and must be given strict effect to by the rules in the trust deed that allow the trustee to appoint or advance capital of the trust estate to a beneficiary.

If a trustee revalues an asset – a credit to an asset revaluation reserve account and a corresponding debit to the asset account – the gain is ordinarily not assessable income of the trust estate. It is merely the means by which the trustee accounts for the trust assets. A distribution to a beneficiary of an amount from an asset revaluation reserve (either in cash or by way of a journal entry) is ordinarily not assessable income of the beneficiary: *Taxation Ruling* 2005/2 at [30]. However:

- (a) a sale of or a dealing with a right to receive such a distribution could result in a receipt of assessable income: *FCT v McNeil* [2007] HCA 5 dealing with the sale of a right by a shareholder of an option to sell back to the company a share.
- (b) further considerations – such as repetition of receipt (see *Interpretative Decision* 2011/58) – may treat it as ordinary income.

### 7.1 Section 99B

It is necessary to consider s 99B of the 1936 Act in this context.

Although the purpose of s 99B of the 1936 Act was to assess trust income that had been accumulated overseas and not subject to Australian tax (as expressed in *Union Fidelity Trustee Co of Aust Ltd v FCT* (1969) 119 CLR 177), its literal terms are much wider than this. In my experience the Commissioner of Taxation does not apply the provision as widely as its literal terms would permit.

Subsections 99B(1) of the 1936 Act would apply to the distribution of the revaluation reserve. The operation of s 99C of the 1936 Act confirms this position. It is important, however, to set out the relevant passage of s 99B(2) of the 1936 Act in full. It provides:

The amount that, but for this subsection, would be included in the assessable income of a beneficiary of a trust estate under subsection (1) by reason that an amount, being property of the trust estate, was paid to, or applied for the benefit of, the beneficiary shall be reduced by so much (if any) of the amount, as represents:

- (a) corpus of the trust estate (except to the extent to which it is attributable to amounts derived by the trust estate that, if they had been derived by a taxpayer being a resident, would have been included in the assessable income of that taxpayer of a year of income);
- (b) an amount that, if it had been derived by a taxpayer being a resident, would not have been included in the assessable income of that taxpayer of a year of income; ...

The operation of s 99B(2)(a) of the 1936 Act was recently considered by the Full Court of the Federal Court in *Howard v FCT* [2012] FCAFC 149. The Court<sup>12</sup> held a resident taxpayer received over \$6 million from a Jersey-based trust, the Esparto Trust. The Esparto Trust had received this amount as part of a share buy-back from another Jersey trust, the Juris Trust. The taxpayer asserted that the amount was a distribution of the corpus of the trust estate and was therefore a capital receipt. The Commissioner of Taxation did not take issue with this assertion, but said the amount was nevertheless assessable under s 99B of the 1936 Act to the extent that it was not assessable under s 97 of that legislation. The Full Court agreed, finding that the amount was caught by s 99B as it would have been assessable if derived by a resident taxpayer (i.e. the exception to the corpus exception in s 99B(2)(a) applied). This was because the distribution represented the proceeds of an off-market share buy-back, which would have been deemed (by s 159GZZZP of the 1936 Act) to be assessable dividends (under s 44 of the 1936 Act).

The Full Federal Court explained the "simple" application of s 99B(2)(a) to the complex facts of the case as follows (at [41]):

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<sup>12</sup> Middleton, Perram and Dodds-Streeton JJ.

In this case, having penetrated two layers of trusts – first the Esparto Trust; then the Juris Trust – one encounters for the first time a non-trust relationship. The trustee of the Juris Trust received non-trust distributions from another Jersey company called Esparto Ltd. Although the process of conjoining Mr Howard to the amounts paid by Esparto Ltd seems complicated, in reality it is not. Section 99B(2)(a) will simply apply as many times as there are interposed layers of trusts. Each application of s 99B(2)(a) leads to a hypothetical question about whether the amounts received by the trust estate would have been assessable income if they had been earned by a resident taxpayer. Once an answer to that question is known at the level of the deepest trust the answer cascades back up to the original (genuine) resident taxpayer. To unpick that slightly: if the Juris Trust estate had been a resident taxpayer and the amounts received by it had been assessable income, then the amounts received by the Esparto Trust, although corpus, would have fallen within the parenthetical excision in s 99B(2)(a) and would have been assessable income in its hands. This, in turn, provides the affirmative answer to the question posed by s 99B(2)(a) as to whether the amounts received by the Esparto Trust estate would have been assessable income on the hypothesis that the Esparto Trust estate was a resident taxpayer. But it is that answer on that hypothesis which applies to Mr Howard himself. What is revealed therefore is not complexity but repetition.

The issue therefore becomes whether the distribution of the revaluation reserve would be assessable to an Australian resident taxpayer. This is so because it is the question for the exception in s 99B(2)(a) and it is the question itself in s 99B(2)(b).

## **7.2 Two Problems with the Asset Revaluation Proposal**

There are two problems with the asset revaluation reserve proposal:

- (a) It may cause CGT Event E4 to occur. See the discussion at heading 6 above.
- (b) The Trust may have received assessable income in a given year. If the trustee has an amount of taxable income in the year of receipt, it should distribute that amount to beneficiaries lest it pay top marginal tax rates pursuant to s 99A of the 1936 Act.

*Private Binding Ruling* PBR 90106 confirms that a distribution from the trustee of a unit trust, sourced from an asset revaluation reserve, is not assessable income of the unitholder, but will trigger CGT Event E4 happening. It is akin to the current situations and confirms the Commissioner of Taxation's views that CGT Event E4 would apply to the distributions.

## **7.3 Accounting Treatment Imperative**

The following case shows the importance of the accounting and administrative treatment of an 'asset revaluation reserve' amount as it can easily be treated as income if the trustee is not particular to maintain the character of the distribution.

Part of Brereton's J decision in *Wood v Inglis* [2009] NSWSC 601 involved the question of whether movements in the value of assets can be treated as income or otherwise distributed to beneficiaries. In that case it was the movement in value of shares held by the trustee. His Honour held at [14] to [17]:

I do not accept that it cannot be said that a profit has been made (or "incurred", for the purposes of clause 10 of the Trust Deed), just because it has not been realized. Comparison of the value of the assets of an entity at the end of the relevant period with their value at the beginning of that period is one well-recognised means of ascertaining profit [*Re Spanish Prospecting Co Limited* [1911] 1 Ch 92 at 98; *QBE Insurance Group v ASIC* (1992) 38 FCR 270 at 284-285]. ...

That conclusion is only reinforced by clause 6(f). I do not accept that the reference in clause 6(f) to "property or moneys held by the Trustee", coupled with the definition of "property", means that the reach of the clause does not extend to "unrealised capital gains"; the purpose of the clause is plainly to avoid disputation as to whether receipts, profits and distributions received by the trust are capital or income by empowering the Trustee to make that determination. The effect of treating "unrealised capital gains" as income is that so much of the value of a share (which is expressly within the definition of "property") as reflects that gain is treated as income. As has already been observed, the proviso contained in clause 6(f) demonstrates that the Trustee may chose to treat as capital in the Trust accounts what is income for income tax purposes (although a specific declaration to that effect is required); likewise it may (and without any such specific declaration) chose to treat as income in the Trust accounts what is capital for income tax purposes. In that context, submissions that "unrealised capital gains" are not income in the ordinary sense of the word are beside the point.

Accordingly, the Trustee was entitled to treat the movements in the net value of investments as income. Accounts prepared on that basis were nonetheless "proper accounts". Moreover, even if the "unrealised capital gains" were not income, they could be distributed as capital under clause 5(a), which gave the Trustee a discretion to apply capital in favour of any eligible beneficiary at any time before the Perpetuity Date.

In that case at [66] Brereton J found that Dr Inglis was the corporate trustee's controlling mind and, therefore, in approving the financial accounts that provided for the unrealized gains being income it was the trustee's determining to so treat those gains. At [67] his Honour also found that Dr Inglis was acting on the corporate trustee's behalf in validly and effectively making distributions to his beneficiary loan account.

In *Clark v Inglis* [2010] NSWCA 144 the Court decided that, for the purposes of the trust deed provision concerning the distribution and allocation of trust 'income' of a year, unrealized gains arising upon revaluation of investments in accordance with a policy of annual 'marking to

market' were property treated as part of a year's income. This issue arose in *Fischer v Nemeske Pty Ltd* [2015] NSWCA 6, but not party argued against that conclusion.

It is therefore clear that the trustee of a trust must properly account for the revaluation reserve lest it run the risk of being assessable to the beneficiary.

## 8 Trust to Trust Distributions

Discreet issues arise when the trustee of a trust estate seeks to distribute to an entity in its capacity as trustee of another trust. They are considered in turn.

### 8.1 Ensure they're a beneficiary

It must be confirmed that the trust deed provides for the receiving trustee, in its capacity as trustee of that particular other trust, is a beneficiary of the first trust.

### 8.2 Rules Against Perpetuities

The 'rule against perpetuities' is a rule that invalidates interests that would otherwise vest too remotely from the time of settlement. The rule came about to prevent settlors ruling from the grave, by controlling property long after their own death. The classic statement of the rule is by Joyce J in *Re Thompson* [1906] 2 Ch 199 at 202:

The rule against perpetuity requires that every estate or interest must vest, if at all, not later than 21 years after the determination of some life in being at the time of the creation of such estate or interest, and not only must the person to take be ascertained, but the amount of his interest must be ascertainable within the prescribed period. The rule may be state thus: A grant or other limitations of any estate or interest take effect in possession or enjoyment at a future time, and which is not, from the time of its creation, a vested estate or interest, will be void ab initio if, at the time when the limitation takes effect, there is a possibility that the estate or interest limited will not vest within the period of a life or lives then in being, or within a further period of 21 years thereafter.

The life or lives in question must be human lives (and not live of animals) and must be mentioned expressly in the settlement. A 'life in being' means a life in being at settlement. It was common practice to name Royal lives, such as 'all lineal descendants of Queen Mary now living'.

The *Perpetuities Act* 1984 (NSW) took effect on 31 October 1984 and applies to settlements from that date. Three reforms it provided were:

- (a) it allowed settlors to specify a fixed perpetuity period of up to 80 years (in South Australia this can now be unlimited);<sup>13</sup>
- (b) it introduced the principle of ‘wait and see’, which no longer voids the settlement on the *possibility* of a remoteness of vesting, but rather will allow the settlement to continue until it is *certain* to vest remotely; and
- (c) it introduced a number of ‘gift saving’ devices.

In this regard it is critical, if establishing a further trust that will be a beneficiary of an earlier trust, that the vesting date of the latter trust does not exceed the perpetuity period of the former trust.

The Commissioner of Taxation tried to argue that, despite the wait and see rule, the possibility of remoteness of vesting rendered a trust to trust distribution invalid for tax purposes. The Court held it was valid: *Nemesis Australia Pty Ltd v FCT* [2005] FCA 1273.

The rule has been effectively excluded for trusts established for the benefit of employees of corporations (s 1346 of the *Corporations Act* 2001 (Cth) and has possibly never applied to unit trusts.<sup>14</sup>

### 8.3 Family Trust Distributions Tax

Where it applies the *Family Trust Distributions Tax (Primary Liability) Act* 1988 (Cth) imposes tax at 45% plus medicare levy on the amount or value of the income or capital a trustee of a trust estate distributes outside of a family group. Its aim is to ensure that the tax benefit from accessing losses of a family trust cannot be transferred to non-family members. It arises where a family trust election or interposed entity election has been made (to which see heading 9 below).

A significant provision is the cognate legislation – *Family Trust Distributions Tax (Secondary Liability) Act* 1988 (Cth) – which renders an Australian resident trust or company liable to tax equal to any amount a non-resident trust estate would otherwise have been liable to pay but which the Commissioner of Taxation considers is unlikely to be recovered.

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<sup>13</sup> The rule has there been abolished by s 61 of the *Law of Property Act* 1936 (SA).

<sup>14</sup> See Glover and von Nessen, *Unintended consequences: International accounting standards, public unit trusts and the rule against perpetuities* (2006) Aust LJ 675 at 689, referred to Ford, *Unit Trusts* (1960) 23 Mod LRev 129.

## 9 Family Trust Elections & Interposed Entity Elections

Family trust elections and interposed entity elections are relevant for the trust loss provisions, company loss rules, franking credit rules, Division 6D of the 1936 Act and the tax file number reporting provisions.

The rules are contained in Schedule 2F to the 1936 Act, which are more broadly the trust loss provisions.

The rules are a recognition by the income tax legislation that a family unit is often one economic entity. Provided the economic benefits do not leave that group significant tax benefits can arise. However, as seen above in relation to family trust distribution tax, significant restrictions follow the making of the elections.

### 9.1 Family Trust Elections

A family trust is a trust that satisfies a family control test at the end of an income year and for which the trustee has made a family trust election. It is critical that there be a particular specified individual because that person's family group is the premise of the various tests. The requirements are set out in Subdivision 272-D of Schedule 2F to the 1936 Act. Some relevant concepts follow.

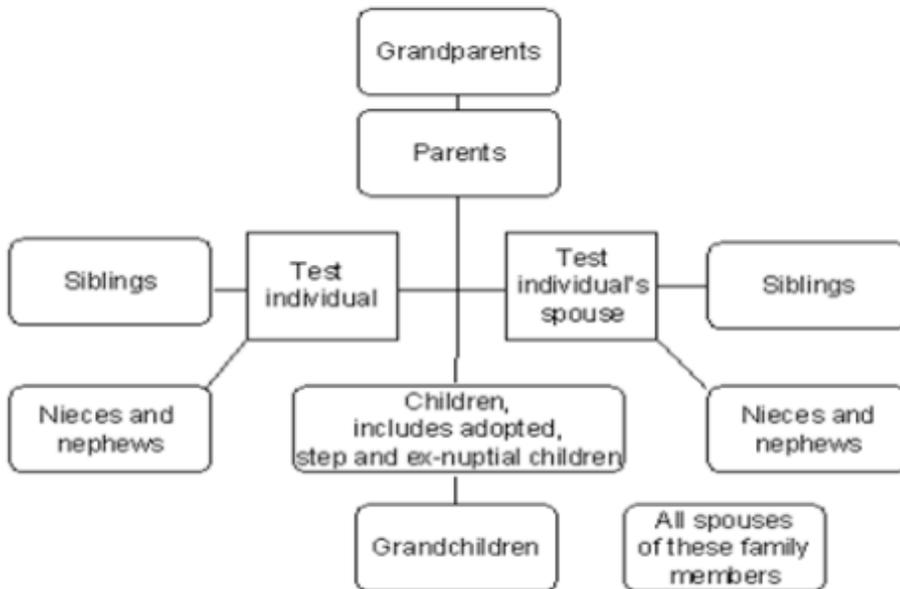
#### 9.1.1 Family Group

The concept of family group is defined in s 272-90 of Schedule 2F by reference to:

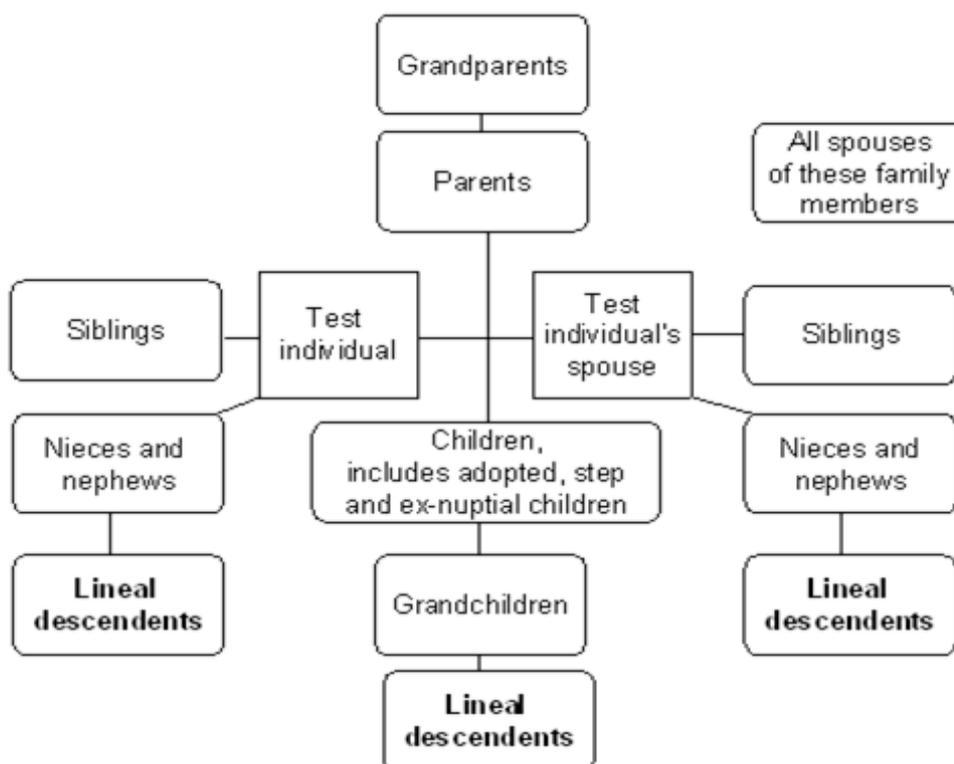
- (a) the family members of the test individual: s 272-90(2);
- (b) the family trust for which the election is made: s 272-90(3);
- (c) another family trust with the same test individual: s 272-90(3A);
- (d) interposed entities that have made an interposed entity election to be included in the family group: s 272-90(4);
- (e) certain other 100% family-owned entities: s 272-90(5);
- (f) estates of the specified individual and family members if all are deceased: s 272-90(9);

- (g) certain persons holding interests in SMEs that have made interposed entity elections: s 272-90(10);
- (h) charities and other institutions covered by the gift deduction provisions or tax-exempt bodies to which distributions are allowed: s 272-90(6), (7) and (8).

The diagram below shows the ‘family’ that applies up until 1 July 2007:



The diagram below shows the ‘family’ that applies from 1 July 2007:



Distributions to those outside the group will attract family trust distributions tax (see heading 8.3 above).

### 9.1.2 Family Control Test

Both a trust (s 272-80(4)) and an interposed entity (s 272-85(4)) must satisfy the family control test before there can be a valid election. The test must be passed at the end of the income year to which the election relates. If the trust does not pass this control test at all times in an income year, the election only starts from the time the trust passes the test and thereafter for the remainder of the income year.

A trust will pass the family control test at a particular time if certain persons control the trust at that time. The range of persons is limited to the individual specified in the relevant family trust election and members of that person's family, as well as legal or financial advisers to either or some combination of those persons: s 272-87(1)).

The test in s 272-87(3) operates when a company or partnership makes an interposed entity election. These entities will pass the family control test if the individuals in the family group of the test individual beneficially hold between them – directly or indirectly – fixed entitlements to more than 50% of the income or capital of the company or partnership.

### **9.1.3 Only one election to be made**

A trustee can only make one election for a trust: s 272-80(11), though see heading 9.1.4 that follows. There are two sets of revocation rules: those that occur for elections in the income years before that ending 30 June 2008 and then the income years thereafter.

### **9.1.4 Rectification of mistaken choice of test individual**

If a trust has, by mistake, chosen one person (A) as the test individual but intended to choose a different person (B) – who must have been alive at the time of the incorrect election and is also a member of A’s family – and the trust has, in the past in its income and capital distributions (and conferrals of present entitlements), only acted on the basis that B was the test individual, the trust may correct its error on a ‘once only’ basis to vary the test individual from A to B: s 272-80(5A) and (5B) of Schedule 2F of the 1926 Act.

As a general rule, for incorrect elections made earlier than 1 July 2004, the correction must have been made before 30 June 2008. For incorrect elections made on or after that date, the correction must be made by the last day of the fourth year after the election was made: s 272-80(6B).

## **9.2 Interposed Entity Elections**

The ability to include other trusts, companies and partnerships within a family trust group allows the election procedure to encompass family group entities that are – in a beneficial ownership sense or, for trusts, in a control sense – between the particular trust and the ultimate beneficiaries. The wider family group can, through the interposed election procedure, escape the trusts loss rules (see heading 12 below) and the wider scheme income injection rules when making distributions through the various family entities.

It seems even a superannuation fund that owns units in a unit trust can make an interposed entity election: *Interpretative Decision* ATO ID 2002/746.

Making an interposed entity election is a prerequisite for a family group entity (that must also pass the family control test) to be included in the family group: s 272-85. If family members, including another family trust of the same specified individual, do not have fixed entitlements – directly or indirectly and for their own benefit – to all the income and capital of the interposed entity, the interposed entity must make an election before it can be included as part of the family group.

Each entity must make its own separate interposed entity election. An interposed entity can make an interposed entity election for more than one family trust if the individual specified in the family trust elections of each family trust is the same: s 272-85(7): see also *Interpretative Decisions* ATO ID 2002/1082 and ATO ID 2004/876. A trust may make both a family trust election and one (or more) interposed entity elections – provided all elections are made in relation to the same specified individual.

The timing rules for interposed entities are much the same as for the family trust to which the election relates: s 272-85(1), (4), (4A) and (6). An interposed entity election is generally irrevocable: s 272-85(5). Obviously, an interposed entity election cannot be made for a company, partnership or trust unless it is controlled by the relevant family from the time the election comes into effect – that is, the election cannot be made if the entity does not pass the family control test at least at the end of the income year: s 272-85(4).

Once the entity passes the family control test, the election will be in effect at all times after the start of the specified day – even if the family trust ceases to exist: *Interpretative Decision* ATO ID 2003/236.

## 10 Implications of Failed Distributions

Incorrect distributions give rise to issues for the distributing trustee and the incorrect recipient.

### 10.1 The distributing trustee

If a trustee pays trust funds to the wrong persons – for whatever reason – the trustee will be liable for a breach of trust even where the trustee made an honest and non-negligent mistake: *Re Hulkes* (1886) 33 Ch D 552. This is so even if the trustee did so on the basis of a forged:

- (a) authority from a beneficiary: *Re Smith* (1902) 71 LJ Ch 411; or
- (b) marriage certificate: *Sutton v Wilders* (1871) LR 12 E1 373.

This also includes where distributions are made to the correct beneficiaries but an overpayment occurs; it remains a breach of trust.

## 10.2 The recipient

The recipient of an improper distribution holds that distribution on constructive trust. They can be ordered to return the distribution to the trustee: *Re Diplock's Estate* [1948] Ch 465. The recipient will not, however, be required to return profits made from the investments of the receipt, unless they have had actual or constructive knowledge that the distribution was in breach of trust: *Perpetual Trustees Co Ltd v Westpac Banking Corp Ltd* (2002) 20 SR (WA) 301.

Proceedings for the recovery of the improper distribution can be taken by the trustee, or persons acting on behalf of the trustee such as a receiver or liquidator, and – with leave of the court – the beneficiaries: *Alexander v Perpetual Trustees WA Ltd* (2004) 216 CLR 109 at [55]. However, the general rule is that defaulting trustee must take proceedings to recover its misapplied trust property and there is no requirement to join the beneficiaries: *Young v Murphy* [1996] 1 VR 279 at 281-283.

## 11 Reimbursement Agreements

Section 100A of the 1936 Act operates where:

- (a) a beneficiary of a trust is presently entitled to a share of income from the trust; and
- (b) the present entitlement arose out of a reimbursement agreement or arose by reason of any act, transaction, or circumstance that occurred in connection with, or as a result of, a reimbursement agreement.

### 11.1 Reimbursement Agreements

A 'reimbursement agreement' is an agreement which provides for the payment of money, the transfer of property to, or the provision of services or other benefits for, a person or persons other than the presently entitled beneficiary or the beneficiary and another person or other person: s 100A(7) of the 1936 Act.

For a reimbursement agreement to exist the agreement must be entered into for a tax avoidance purpose: s 100A(8) of the 1936 Act. It is an anti-avoidance provision.

Section 100A of the 1936 Act was introduced to prevent trust stripping arrangements where trust income was diverted to third parties and away from the truly intended beneficiaries of a trust

under a scheme where the truly intended beneficiaries or an associate would in return receive a non-taxable amount or benefit. Section 100A operates to prevent these trust stripping schemes by taxing the trustee on the income subject to the present entitlements at the rate of 49.5% under s 99A of the 1936 Act.

### **11.2 Corporate beneficiary**

Conceivably, s 100A could apply to the practice of making unpaid distributions to a corporate beneficiary since the corporate beneficiary is presently entitled to the income of the trust and the present entitlement may be considered to arise out of a reimbursement agreement. That reimbursement agreement being the provision of a benefit to the trustee of the trust in being able to keep the money which is the subject of the present entitlement for an indeterminate period of time. The tax avoidance purpose would relate to the fact that the corporate beneficiary's marginal tax rate is lower than other trust beneficiaries' marginal tax rates.

The critical issue underpinning this interpretation of s 100A is whether the corporate beneficiary's allowing of the trustee to retain the funds which are the subject of the present entitlement can be considered to be the provision of a "benefit".

Prior to the Full Court of the Federal Court decision in *Corporate Initiatives Pty Limited v FCT* [2005] FCAFC 62 one would have thought that there was a reasonable argument to say that a corporate beneficiary who is merely passive and does not seek to call for the payment of an unpaid present entitlement owed to it by a trust, could not be considered to be giving a benefit to the trustee. All that the corporate beneficiary has done is essentially remain passive. In *Corporate Initiatives*, albeit in the different context of the trust income injection provisions of Division 270 of Schedule 2F of the 1936 Act, the Full Court of the Federal Court accepted an argument that a beneficiary's failure to call for payment of its unpaid present entitlement constituted the provision of a "benefit" to the trustee since it allowed the trustee to retain use of the funds covered by the present entitlement.

This argument has now been applied by the Commissioner of Taxation in relation to unpaid present entitlements generally: see *Taxation Ruling 2010/3* and *Practice Statement PSLA 2010/4*.

Arguments against the application of s 100A of the 1936 Act to the practice of making unpaid distributions are basically twofold:

- (a) The first argument relies on the fact that reimbursement agreements that are entered into ‘in the course of ordinary family or commercial dealings’ are excluded from s 100A’s operation: s 100A(13). Arguably, since this practice of providing corporate beneficiaries with unpaid present entitlements is common in the commercial market place and with family groups the practice is shielded by this exception. The term ‘in the course of ordinary family or commercial dealings’ is, however, very vague and reminds one of John Howard’s pronouncement that Part IVA of the 1936 Act is not aimed at such dealings.
- (b) The second argument against s 100A applying relies on a purposive approach to interpreting the section rather than a literal approach. The background of s 100A shows that it is aimed at trust stripping arrangements where a third party becomes involved in a trust so as to soak up excess trust income at a lower tax rate and then distributes that income back to the true beneficiaries of the trust after taking out a fee for their services (see Hill’s J discussion of trust stripping in *East Finchley Pty Limited v FCT* (1989) 20 ATR 1623 at pages 1637-1638). Arguably, since a corporate beneficiary would have been listed as a beneficiary of the trust since its inception, then no trust stripping has occurred as the corporate beneficiary is one of the truly intended beneficiaries of the trust.

In any event, but subject to heading 11.3 that follows, the Commissioner of Taxation’s approach to Division 7A and trusts – set out in *Taxation Ruling 2010/3* and *Practice Statement PSLA 2010/4* – has largely overtaken this issue of s 100A.

### 11.3 Wholly Owned Corporate Beneficiary

Where the Commissioner’s Division 7A has not overtaken s 100A is in relation to wholly owned corporate beneficiaries.

Relevant in this regard is the Commissioner of Taxation’s publication *Trust taxation – Reimbursement Agreements*. It was issued on 21 August 2015. It says:

A reimbursement agreement generally involves making someone presently entitled to distributable income of a trust in circumstances where both:

- someone else actually benefits from that income, and
- a purpose of a party to the agreement is obtaining a tax benefit.

Although a wholly owned corporate beneficiary, to whom the distributions are actually paid and on which tax is assessed by, and remitted to, the Commissioner of Taxation would not fall within this description – because no one else actually benefits from the declaration, other than the company and, in due course, the recipients of its dividend payments – the Commissioner goes so far as to suggest this may be caught by s 100A. In fairness to the Commissioner of Taxation example 5 therein also includes an washing of dividends each year in a non-commercial way, but numerous statements from ATO officers confirms the Commissioner is unlikely to accept a wholly owned corporate beneficiary as escaping s 100A.

The consequence of this in a usual family structure is the establishment of a second trust to hold the shares of the company that is a beneficiary of the first trust. Rules against perpetuity are here relevant as they need to ensure the vesting date of the second trust is not after the perpetuity period of the first trust.

## **12 Amending a Trust Deed**

The ability to amend a trust may arise in the trust terms or otherwise. Given that resettlements are discussed elsewhere, and the terms of a trust empowering amending will be governed by the deed specific wording this paper will focus on approaching the Court to seek powers to amend

### **12.1 Amending Generally**

The term “power of appointment” can mean two different things: a power to amend the trust instrument and a power to appoint or consent to a change of trustee, nomination or exclusion of beneficiaries or nomination or exclusion of appointors and guardians. At trust law there is no distinction between a “power of appointment” and a “power of amendment”: Kessler & Flynn, *Drafting Trusts & Will Trusts in Australia*, Thomson Lawbook Co, 2008 at [10.10] and [10.35]. But this paper will consider the power to amend the trust terms.

A trustee has no inherent power to amend a trust instrument and the power of amendment in the trust instrument (if there is one) is construed strictly in respect of any conditions on the exercise of the power: *Global Custodian Ltd v Mesh* [2002] NSWSC 283 at [18]; *Kearns v Hill* (1990) 21 NSWLR 107. As discussed below, the court may amend a trust instrument without a sufficient power of amendment in that instrument itself: *Re The Alan Synman Trust* [2013] VSC 364.

The power of amendment is construed within the surrounding context of the trust deed and any extrinsic evidence and ought not to be construed in a narrow or unreal way: *Jenkins v Ellett* [2007] QSC 154 at [15]. The power must be given its natural meaning and interpreted (within the strict reading of conditions for exercise) to give its most ample operation: *Kearns v Hills* 21 NSWLR 107 at 109.

A summary of the principles of amendment are:<sup>15</sup>

- (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* [2015] WASC 297, though see on appeal at [2016] WASC 206;
- (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:

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<sup>15</sup> These are taken from the detailed and thorough paper of Ron Jorgensen, *Managing Trust Deed Amendments*, 10 April 2016

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

## 12.2 Re Dion

On 30 October 2014, in *Re Dion Investments Pty Ltd* [2014] NSWCA 67, the Court of Appeal<sup>16</sup> of the New South Wales Supreme Court further clarified the ability of trustees to seek additional powers from the Courts under s 81 of the *Trustee Act* 1925 (NSW).<sup>17</sup>

*Re Dion Investments Pty Ltd* is of interest for a number of reasons, the primary one being what will, or will not, be a ‘transaction’ for the purposes of s 81. The practical effect of the decision is that a trustee cannot seek from the court a general power to amend the terms of the trust going forward – an omission of such a power is now permanent in New South Wales. The trustee can, however, seek specific powers, even for the purposes of obtaining tax advantages, if s 81 is otherwise satisfied.

### 12.2.1 Background

The Dion Family Trust was established in 1973. Its current trustee, Dion Investments Pty Ltd, sought the opinion, advice or direction of the Supreme Court under s 63 of the *Trustee Act* to the effect that it had power to make certain amendments to the instrument by which the settlement trusts were declared. There was an alternative claim under s 81(1) of the Act conferring on Dion Investments Pty Ltd as trustee power to make amendments and certain other specific powers.

At first instance Young AJ declined to provide the judicial advice sought<sup>18</sup> and in fact advised the trustee would not be justified in proceeding on the basis that it had power to amend the trust instrument. In response to the s 81(1) claim his Honour made an order intended to confer certain of the requested specific powers but declined the other specific powers or the power to amend generally.

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<sup>16</sup> Per Barrett JA, Beazley P and Gleeson JA agreeing at [1] and [117] respectively.

<sup>17</sup> The ‘**Trustee Act**’.

<sup>18</sup> *Re Dion Investments Pty Ltd* [2013] NSWSC 1941.

On appeal Dion Investments Pty Ltd as trustee did not press the judicial advice claim but sought the powers requested under s 81(1) of the Trustee Act: see at [7]. Dion Investment Pty Ltd's proposal in relation to the s 81(1) claim was for it to be granted specific powers to:

- (a) define "year" as a period from 1 July to 30 June;
- (b) allow the trustee to pay or allocate capital gains even if no other income is derived in a year;
- (c) give the trustee broad powers to determine what is income or capital;
- (d) enable the trustee to maintain multiple income accounts and be able to credit or debit those accounts with income or capital as the trustee considered fit; and
- (e) make broader investments, including the drawing of bills of exchange and like matters,

and a provision empowering the trustee, with the consent of any appointer (though there was apparently none for the Dion Family Trust), to revoke add to or vary all or any of the trusts, terms and conditions of the deed and to declare, revoke and vary new trusts concerning the trust fund or any part of it, subject to the provisos against infringement of the rule against perpetuities and interference with amounts already set aside for beneficiaries.

The reason the powers were sought was to 'modernise the trust deed'.<sup>19</sup> It was clear, however, that this was to be done to benefit under the income tax legislation. The Court at [19] to [25] considered an advice of KPMG to the effect that a better tax outcome would be achieved if, amongst other things, the trustee of the trust had the power to classify receipts as income or capital and stream those amounts (together with franking and other credits) to particular beneficiaries. In the context of the Trustee Act this had relevance for the reasons given at [25]:

The question whether a beneficiary is "specifically entitled" to a particular item thus turns on the beneficiary's actual or expected receipts "in accordance with the terms of the trust". And of central importance in answering the question are "the terms of the trust deed (if any)", "the terms applicable to the trust because of the operation of legislation, common law or the rules of equity" and powers "conferred by the terms of the trust."

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<sup>19</sup> Mr L F Dion, a director of the corporate trustee, deposed it was to 'modernise the trust deed to empower the trustee of the trust to better manage the trust property for the benefit of the beneficiaries, such as by allowing the trustee to separately identify and distribute different types of income and capital with consequential taxation benefits.'

Only if some relevant entitlement can be found in or seen to be derived from such “terms” or the exercise of a power “conferred” by such “terms” can advantage be taken of the streaming provisions. And importantly, the “terms” of a trust are not confined by the content of the trust instrument (if there is one).

It will be seen that the difference between the terms of the trust and the trust deed is an important distinction to bear in mind.

### 12.2.2 *What is a transaction?*

*‘A point extensively explored in argument before [the] Court [was] whether amendment of the trust deed is a “transaction” for the purposes of s 81.’* That was because the general power to amend the trust terms did not fall within the other descriptors of s 81 of the Trustee Act. Justice Barrett said at [88]:

The court may, under s 81(1), “confer upon the trustees, either generally or in any particular instance, the necessary power for the purpose” of effecting, “in the management or administration of any property vested in trustees”, “any sale, lease, mortgage, surrender, release or disposition, or any purchase, investment, acquisition, expenditure or transaction” that cannot be effected “by reason of the absence of any power for that purpose vested in the trustees by the instrument, if any, creating the trust, or by law”.

The dealings that may thus be facilitated by a court fall into two classes:<sup>20</sup>

- (a) first *‘any sale, lease, mortgage, surrender, release, or disposition’*, each of which describes a dispositive act of an owner of property by which the property or some interest in it passes or accrues to another person; and
- (b) second, *‘any purchase, investment, acquisition, expenditure, or transaction’*, all of which but “transaction” concentrate principally on ways of deploying money.

The Court held at [91] that:

“Transaction”, of itself, does not imply an outlay of money. Nor should any such limitation be taken to be indicated by the fact that the reference to “transaction” comes immediately after references to “purchase”, “investment”, “acquisition” and

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<sup>20</sup> See *Re Dion Investments Pty Ltd* at [89] and [90] per Barrett JA.

“expenditure”. A “transaction” that in fact involves an outlay of money is certainly in contemplation. But so to, in my view, is one that does not.

The question became, therefore, whether the power to amend in the future was a “transaction”. After considering a number of recent cases (largely in New South Wales but also interstate and foreign) on the issue, the Court held that granting a trustee the power to amend the terms of trust was not a “transaction” for s 81 purposes. Although lengthy much of the passage of [97] to [100] bears repeating:

Conferral of specific new powers pursuant to s 81(1) should not be by way of purported grant of authority to amend the trust instrument so that it provides for the new powers. Rather, the court’s order should directly confer (and be the sole and direct source of) the powers which then supplement and, as necessary, override the content of the trust instrument. And, of course, the only specific powers that can be conferred in that direct way are those that fall within the s 81(1) description concerned with management and administration of trust property.

If the power to be given to the trustee is not a specific power with respect to a particular dealing (or dealings of a particular kind), but, rather, a wide discretionary power to alter the terms of the trust as the trustee thinks fit, the case is not within s 81(1). ...

If, under the guise of giving the trustee a power to undertake a “transaction” of amending the trust deed by adding a comprehensive and virtually unrestrained amendment provision, an order is made that purports to put the trustee into a position from which it can make all and any alterations to the terms of the trust it thinks desirable, the court takes the impermissible course of both appropriating to itself and giving to the trustee a “general power to depart from the precise directions ... that a settlor thought proper to declare (*Downshire*<sup>21</sup>) at 247). Because there is no “proposed transaction ... which is specifically related to the management or administration by trustees of trust property, *quoad* property” (*Downshire* at 252), the matter is not within the scope of the section.

For these reasons, I share the opinion of the primary judge that the post-1997 decisions that have proceeded on the basis that variation of the terms of a trust is, of itself, a “transaction” within the contemplation of s 81(1) rest on an unsound foundation. The court is not empowered by the section to grant power to the trustees to amend the trust instrument or the terms of the trust. It may only grant specific powers related to the management and administration of the trust property, being powers that co-exist with (and, to the extent of any inconsistency, override), those conferred by the trust instrument or by law.

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<sup>21</sup> *Re Downshire Settled Estates* [1953] Ch 218.

The Court allowed the appeal to the extent that the five specific powers were granted, but declined to empower Dion Investments Pty Ltd to further amend the terms of trust: see at [108] to [110].

Various cases<sup>22</sup> now no longer represent the law in New South Wales. That is, a trustee without power to amend the terms of the trust cannot obtain that power from the Court. The omission of a power to amend in a trust's terms is therefore a permanent omission, at least in New South Wales.

Justice Barrett also confirmed three further matters on the way to resolving the issues before the Court.

### ***12.2.3 Overriding or supplementing – no variation***

First, the Court made clear that it was not amending the terms of the trust instrument, but allowing specific powers that supplement – or, if in conflict, override – the terms of the trust. At [109] Barrett JA said:

As to [the specific powers], the primary judge correctly rejected the proposition that an order under s 81(1) could empower the trustee to amend the trust deed by incorporating new terms as proposed. A result generally sought by Dion Investments Pty Ltd may, however, be achieved by orders under s 81(1) that directly confer powers which supplement and, as necessary, override the provisions of the trust instrument.

Applications under s 81(1) of the Trustee Act, therefore, are properly seen as obtaining additional powers to supplement or override, rather than amend, existing terms of the trust (usually, but not necessarily, set out in a trust instrument).

### ***12.2.4 Terms of Trust vs Trust Deed***

Second, [40] to [48] Barrett JA took time to explain that while it may be commonplace and convenient to speak of amending a trust deed, what actually occurs is a supplementation of the terms of the trust. His Honour summarised it thus at [44]

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<sup>22</sup> See, for instance, in New South Wales, *Re Bowmil Nominees Pty Ltd* [2004] NSWSC 161 per Hamilton J, *James N Kirby Foundation Ltd v Attorney-General (NSW)* (2004) 62 NSWLR 276 per White J, *Stein v Sybmore Holdings Pty Ltd* [2006] NSWSC 1004 per Campbell J (as his Honour then was), *Re NSFT Pty Ltd* [2010] NSWSC 380 per Biscoe AJ, *Barry v Borlas Pty Ltd* [2012] NSWSC 831 per White J and *Re Grant* [2013] NSWSC 1603 per Slattery J; and elsewhere *Colonial Foundation Ltd v Attorney-General (Vic)* [2007] VSC 344 per Smith J, *Hutchinson v Attorney-General* [2009] VSC 551 per Habersberger J and *Ballard v Attorney-General* (2010) 30 VR 41 per Kyrrou J.

It is, of course, commonplace to speak of the variation of a trust instrument as such when referring to what is, in truth, variation of the terms upon which trust property is held under the trusts created or evidenced by the instrument. A provision of a trust instrument that lays down procedures by which it may be varied is, of its nature, concerned with variation of the terms of the trust, not variation of the content of the instrument, although the fact that it is the instrument that sets out the terms of the trust does, in an imprecise way, make it sensible to speak of amendment of the instrument when the reference is in truth to amendment of the terms of the trust.

This is confirmed by the tax consideration, where it is the terms of the trust together with the relevant legislative, common law or equitable influences thereon that determine a specific entitlement.

His Honour concluded this reasoning at [48] in the following way:

Whether one is dealing with exercise of a power of variation or amendment conferred by the settlor and stated in the trust instrument, the species of consensual variation based on the *Saunders v Vautier* principle or the court's response to some emergency, the situation is never one in which the provisions of the trust instrument made between settlor and trustee are altered. Rather, there is a variation or supplementation of the terms of the trust derived from that instrument or the powers of the trustee conferred by that instrument. Shorthand references to amendment of a trust deed must be understood accordingly.

It is therefore important to remember we are considering additions to the terms of any given trust rather than the form of the instrument that may have established the trust.

#### ***12.2.5 Value of Trust Fund for Leave to Appeal***

Third, and finally, it was confirmed that it is the value of the corpus of the particular trust that is relevant for determining whether leave to appeal is required. By s 101(2)(r)(ii) of the *Supreme Court Act 1970* (NSW) an appeal to the Court of Appeal requires leave unless it '*involves a matter at issue amounting to or of the value of \$100,000 or more*'. The Court at [5] confirmed<sup>23</sup> that:

Contrary to the position taken by Dion Investments Pty Ltd, there is no requirement for leave to appeal. This follows from the fact that, according to the material before the primary judge, the value of the trust property far exceeds the threshold of \$100,000 referred to in s 101(2)(r)(ii).

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<sup>23</sup> Citing *Beck v Henley* [2014] NSWCA 201 at [58] per Leeming JA (Beazley P and Sackville AJA agreeing at [1] and [97] respectively).

Understandably, in the absence of confirmation on this point counsel for Dion Investments Pty Ltd sought leave to ensure the argument, that seeking a power to deal with property does not include the value of that property, was not fatal to the appeal.

#### ***12.2.6 Conclusion on Re Dion***

*Re Dion Investments Pty Ltd* is significant as it confirms the lack of foundation of many earlier decisions, that enabled a trustee the power to further amend a trust's terms. A trustee's only recourse under s 81(1) of the Trustee Act is to seek specific powers by way of supplementation or overriding of the existing trust terms. The trustee of any trust the terms of which omit the power to amend, revoke or vary will have a much more difficult time 'modernising' the trust terms following this decision. Given Dion Investments Pty Ltd was the only party, and is presumably satisfied with the orders made, no special leave is likely to be sought. This decision will therefore stand for the foreseeable future.