

Trust Distributions after **Bamford**

A message for advisers and trustees – Review all discretionary trusts

Do I need to update a deed? You may not have to. The Bamford and Forrest decision provide a clear message that the “wording of the trust deed” is important. A deed with wrong clauses should be amended but not all deeds will contain clauses of concern. Two deeds from the same source can be very different, so all must be checked.

This paper provides guidance to practitioners to enable them to review each client discretionary trust deed, preferably prior to 30 June 2024. This may avoid costly individual review and amendment. There are three key steps:

1. Understand what each discretionary trust deed says “income” and what “Tax Act” the deed refers to
2. Amend deficient trust deed provisions preferably before 30 June 2024
3. Alter office practices regarding preparation of trust Distribution resolutions where these documents expose the client to adverse tax issues

We provide a free template for distribution resolutions post-Bamford.

1. Trust Income & Tax Act

The Australian Taxation Office had long adopted the view that no matter what the Trust Deed says, the only true income of the Trust estate is income “according to ordinary concepts”. Lawyers and tax specialists have argued that the Trust Deed must be read as the Deed defines what is income and what the Trustee must deal with.

Section 3 of this Explanatory Memorandum should be read. It contains detailed examples of the meaning of “income” following Bamford.

Two decisions have been considered in the High Court and Full Federal Court, respectively, on the issue of the wording of the Trust Deed. Both the Bamford and Forrest decisions provide guidance that the terms of the Trust Deed must be read. Those terms may be to the benefit or detriment of taxpayers. The Commissioner’s opinion has been tested and found invalid.

The Bamford decision is a tremendous outcome for trustees. The ATO sought to tax the trustee on capital gains under s99A rather than taxing beneficiaries. The Full Federal Court disagreed with this concept. The High Court has upheld the FCC decision.

The issue that advisers must now consider after the Bamford decision is “what is the income of each trust?” and how is it “shared”?

Tax advisers are also faced with the view that accounting software produces the tax value of income, and they balance this with the professional views of their membership bodies that often define income according to Accounting Standards. Mr Carramatta, accountant for Bamford, provided the AAT with evidence in his affidavit that “accounting standards...required the capital profit...to be taken to revenue account.”

Mr Carramatta’s position is typical of the dilemma faced by every accountant – How do I deal with the difference between accounting concepts and taxable income? The Bamford decision provides that guidance.

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Every discretionary trust and hybrid discretionary trust should now be reviewed to determine “what is income?”

It is dangerous to suggest that all deeds should be updated. This could be costly and cheap online updates cannot be relied upon if they are not professionally prepared. Alteration of the deed may trigger a trust re-settlement with CGT duty consequences.

MGS recommend that the accountant review each deed first. Then, each client tax file should be referred to competent and qualified deed practitioners such as MGS for review and amendment.

What to look for:

1. Income

- Definitions of “income” that do not refer to both ITAA36 and ITAA97
- Definitions of “income” that only refer to ITAA36 are problematic as capital gains are determined by ITAA97
- Definitions of “income” that refer to general accounting principles, accounting standards or other broad measures
- Definitions which grant the trustee a discretion to determine how income is determined
- Income definitions in a discretionary trust which excludes capital gains which will be distributed using some other mechanism including a separate discretion

2. Tax Act

- The deed should refer to both ITAA36 and ITAA97

Practitioners should summarise the clauses of concern and refer to issue 2 below.

Notes on how income is determined should be placed prominently within office files such as a tax file.

2. **Amend Deficient Deeds**

Advisers should only refer trust deeds that have clauses of concern for possible amendment. This process will minimise unnecessary cost. Review and amendment due to creation of fear by some deed providers means those providers should be avoided. A reliable provider will suggest a solution not just the problem. Suggesting every trust needs to amend its deed is unnecessary and we would suggest that such a statement is misleading and deceptive.

A reliable deed provider should assist by:

- Review of the clauses of concern noted by the accountant
- Preparation of a Deed of Amendment that has been settled by a lawyer that corrects clauses of concern without resettling the trust

MGS is a deed provider that can provide a Deed of Amendment that satisfies the above concerns.

MGS would not recommend replacement of any discretionary trust deed due to the potential for trust resettlement.

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3. Alter Trust Distribution Practices

The Bamford case carefully considered and was the test case for what “share” of income means in s97 (1)(a) of ITAA36.

Failure to share income correctly may result in amended assessments which do not agree with the intentions of the tax adviser. This may expose advisers to professional negligence issues.

Two approaches had previously been argued to the Federal Court. The quantum approach and the proportionate approach had been considered, however by a single judge on each occasion. A third approach, the “hybrid approach” was argued by Mr Slater QC in Bamford.

In Bamford the Full Court of the Federal Court found in favour of the proportionate approach.

Emmett J in the delivery of the principal decision to the FFC makes this clear:

“‘share’ in s97(1) refers to the beneficiary’s proportion or fractional entitlement to the income of the trust estate. Thus, a beneficiary presently entitled to income of the trust estate in a given year will have included in that beneficiary’s assessable income the proportion of the net income of the trust estate equal to the proportion that the income...bears to the income that has been distributed during the year or remains available...it is erroneous to treat ‘that share’ as referring to a fixed amount.”

The proportionate approach is uncomplicated. Regardless of the formulation of the income that applies it is whatever share of income, which is enjoyed by a beneficiary, the beneficiary will have the same proportionate share of the net income of the trust.

The wording of the deed, however, will affect how “share” is applied.

Example A

Deed adopts ordinary concepts – Trust Resolution

- Beneficiary A (Minor)	\$600
- Beneficiary B (Minor)	\$600
- Beneficiary C	\$5,000
- Beneficiary D	\$3,800

Total **\$10,000**

However, let us assume that income includes a non-deductible expense of \$2,000.

Deed adopts ordinary concepts – s97(1) tax result

- Beneficiary A (Minor)	\$720
- Beneficiary B (Minor)	\$720
- Beneficiary C	\$6,000
- Beneficiary D	\$4,560*

Total **\$12,000**

However, if the original distribution had used a “balance beneficiary” the outcome would have been

Example B

Deed adopts ordinary concepts – Trust Resolution

- Beneficiary A (Minor)	\$600
- Beneficiary B (Minor)	\$600
- Beneficiary C	\$5,000
- Beneficiary D.	\$Balance(\$3,800)

Total **\$10,000**

However, let us assume that income includes a non-deductible expense of \$2,000.

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Deed adopts ordinary concepts – s97(1) tax result

- Beneficiary A (Minor)	\$720*
- Beneficiary B (Minor)	\$720*
- Beneficiary C	\$6,000*
- Beneficiary D	\$4,560*
Total	\$12,000

A balance beneficiary does NOT derive the tax adjustment. All beneficiaries receive a share

Use of Section 95(1) Principles

If the deed has adopted s95(1) terms, the use of a “balance” beneficiary has an altered outcome.

The effect of adopting s95(1) terms and using a balance method of distribution isolates any tax adjustment to the hands of a specific beneficiary. Fixed distributions to other beneficiaries are unaffected. This may be particularly desirable where beneficiaries are non-resident taxpayers, minors or the impact of an adjusted distribution is desired to be avoided.

What if there is no balance beneficiary but there is a default beneficiary? If s95(1) terms are adopted (by the term of the Deed or in the exercise of discretion) then the outcome will ensure that the balance (i.e. the tax adjustment amount) is attributable to the balance beneficiary and the balance beneficiary can call on that amount to be paid to it. However, care needs to be exercised in deeds which provide a default beneficiary that is a charity, for example. The trustee may not have the funds to pay the entitlement. Most trust deeds provide the trustee with the power to borrow.

Example C

Deed adopts s95(1) – Trust Resolution

- Beneficiary A (Minor)	\$600
- Beneficiary B (Minor)	\$600
- Beneficiary C	\$5,000
- Beneficiary D	\$Balance (\$3,800)
Total	\$10,000

However, let us assume that income includes a non-deductible expense of \$2,000.

Deed adopts s95(1) – tax result with a Balance Beneficiary

- Beneficiary A (Minor)	\$600
- Beneficiary B (Minor)	\$600
- Beneficiary C	\$5,000*
- Beneficiary D	\$5,800*
Total	\$12,000

Deed adopts s95(1) – tax result with a Default Beneficiary

- Beneficiary A (Minor)	\$600
- Beneficiary B (Minor)	\$600
- Beneficiary C	\$5,000
- Beneficiary D	\$3,800
- Beneficiary D (Default)	\$2,000*
Total	\$12,000

The Issue of “Income”

The Full Court in Bamford concluded that “the income of the trust estate” is to be determined by reference to the terms of the trust itself. This is a blow to the Commissioner’s long-standing view that the terms of the trust deed have no reference. The High Court dismissed this opinion.

If the trustee is entitled to treat a capital gain as income according to the terms of the trust deed, it will be part of the “income of the trust estate” for determining the proportion of the trust income accessible to the beneficiaries.

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Emmet J points out that if the deed is silent about the basis on which income is to be determined, income according to ordinary concepts operates. However, if the deed adopts accounting income or s95(1) concepts then they prevail. This decision in Bamford is consistent with the decision in Cajkusic.

“Income of the trust estate” is determined with reference to the deed in the following manner and order.

1. If the deed is silent “income of the trust estate” is determined according to ordinary concepts;
2. If the deed adopts income according to accounting standards, then that concept prevails; and
3. If s95(1) concepts are adopted, then calculations used to determine net income prevail. This can pose some problems in special circumstances.

Problems with s95(1) Principles

Many deeds contain the terms to the following effect:

“Income means an amount calculated in accordance with s95(1) of ITAA 1936”

The impact of using such a clause is there can never be a difference between income of the trust and net income. If the Commissioner changes net income of the trust, either:

1. The adjustment will be shared proportionately if the distribution was originally exhaustive and there is no default beneficiary;
2. Where there is a default beneficiary and no balance beneficiary, the default beneficiary will be assessed;

3. The balance beneficiary receives the adjustment distribution

It is essential that the trustee and the tax adviser both understand what income concept operates for a particular deed and the terms on which the trust distributions will be made. Specific notes on this should be made and clearly placed in a place that reminds the trustee and adviser, from time to time, so that adverse outcomes do not occur.

In some cases, it may identify that the trustee should change the trust deed. A Deed of amendment should be prepared to do this, and it should then be attached to or with the original deed/s.

The tax adviser needs to also pay attention to reconciling the financial statements and accept that income entitlements under the deed may differ. A reconciliation between accounting income and taxable income will assist clients.

Financial statements should reflect consistency with the rights and entitlements of the beneficiaries.

Trustee Minutes/Resolutions

Definitions:

Minutes: An official record of what is said or done during a meeting

Resolution: A formal expression of consensus arrived at after discussion and usually the result of a vote

Professional advisers and trustees need to be mindful that the records of a trust are legal documents. The Australian Taxation Office may seek further information in support of a trust distribution. The AAT frequently deals with taxpayers who either

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fail to produce documents or, worse still, produce documents that refute their argument. It is essential that such important records be correctly prepared, maintained and retained.

Document retention for a trust is important. The Deed/s and records of unitholders (where relevant) should be carefully safeguarded, and all decisions of the trustee maintained in the register that is signed, dated and permanently retained.

What should the Resolution consider, after Bamford?

- S95 or s97 principles?
- Fixed distributions to minors and others
- Balance beneficiary
- Default beneficiary

Minutes or a Resolution?

At MGS we do not recommend minutes be maintained. Typically, a minute will describe the actions, discussions, and outcomes of one, or more, people. The trustee must be placed in a position where they can stand in a court and declare that a meeting did occur and that the record is true.

Often minutes are prepared by the tax adviser and accompany the completed financial statements. In many cases no such meeting took place. The trustee cannot declare such minutes to be true. A resolution, however, describes a record of the decision and not the meeting. A resolution takes effect upon the final signature. So, if the tax adviser were to prepare such a document, it fairly represents a true resolution upon the parties signing it. It is not necessary to state that a meeting took place at a particular place and time. It is necessary to indicate

that upon a certain date the trustees considered a matter and resolved a particular outcome (i.e. a distribution).

MGS recommend that all trustee resolutions be prepared and retained that support the distribution of income. The resolution/s should be carefully prepared and checked such that they are consistent with the financial statements, income tax affairs and, importantly, the trust deed.

If a trustee is unsure of the wording, or its meaning, in a trust deed they should seek the guidance of their tax adviser or legal adviser.

Macquarie Group Services provides a FREE copy of the suggested resolution template for the use of trustees at macquariegs.com.au under "Documents". Access is available to registered users. Registration is free and without obligation to purchase.

MGS is a compliant supplier of trust deeds, companies, self-managed fund and other precedents.

Endnote/References

- Bamford v F C of T [2008] AATA 322 and Bamford v FCT [2010] HCA 10 - March 2010
- Forrest v FC of T [2010] FCAFC 6
- Merkel J in Richardson v F C of T [1997] FCA 1273
- Sunberg J in Zeta Force Pty Ltd v F C of T [1998] FCA 728
- Cajkusic v F C of T [2006] FCAFC 104

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