

Taxation of Trusts

What is a trust?

- A trust is not a separate legal entity but a relationship
- **Div 6 ITAA36** contains the key legislative provisions relating to the taxation of trusts
- Trust means an obligation enforceable in equity that rests on the trustee as owner of the trust property to deal with that property for the benefit of the beneficiaries or for some object or purpose.
- Beneficiary has equitable rights against the trustee, which depend on the terms of the trust (can be implied or express as established formally with a trust deed)

Fixed Trusts

- The trustee is obligated to pay the income or capital of the trust in precise fixed proportions (pursuant to the Trust Deed) to specified beneficiaries
- **Unit trusts**
 - A unit under the trust deed confers a proprietary interest in all of the property which for the time being is subject to the trust of the deed: *Charles v FCT*.
 - The beneficiaries of a unit trust are entitled to a fixed proportion of the net income or capital under the trust deed, and the trustee has no discretion to change the fixed entitlement.
 - The share of net income and capital of a unit trust is determined by the number of units held by the beneficiary, which typically corresponds to the contribution made to the trust by the beneficiary

Discretionary Trusts

- Trustee has absolute discretion to allocate trust income or capital to the beneficiary
- Beneficiary has no entitlement to trust property until the trustee decides
- Useful for asset protection in case of beneficiaries becoming bankrupt
- Family trust typically established and operates as follows:
 1. Main beneficiary appoints trustee as an 'appointer', who is nominated in trust deed and has the power to remove/appoint a trustee
 2. Establishment of trust when Settlor (usually family accountant or solicitor) makes initial cash contribution (usually \$20) and executes trust deed
 3. Trustee is the legal owner of the trust property, and administers said property on the behalf of beneficiaries (current and future family members)
 4. Trustee distributes income to beneficiaries - Trustee can split income taking into account the tax profiles of the beneficiaries.
 - a. E.g. if a beneficiary has carried forward capital losses, the trustee may decide to distribute more capital gains to that beneficiary to minimise the tax liability of the capital gain

- b. However, the Commissioner may apply the **general anti-avoidance provisions in Pt IVA ITAA36** if s/he opines that the dominant purpose of entering into the arrangement is for the tax benefits.

Testamentary Trusts

- A trust created under a will and can either be a fixed trust or discretionary trust
- Beneficiaries can be the widow or widower, and children or grandchildren

Step 1: Calculate the net income or loss of a trust

- (CHOOSE) **Trust losses** CANNOT be distributed to the beneficiary, and may be carried forward in the trust to offset against future income derived by the trust
- (CHOOSE) Since the trust **has net income**, the next step is to determine who should be the taxpayers for the amount.

Step 2: Who's the TP for the net income of trust?

- (CHOOSE) **Beneficiary is PRESENTLY ENTITLED to the trust income and is NOT under a legal disability**
 - Under **s97 ITAA36**, given that the beneficiary is not under any legal disability and is presently entitled to **a share of the income of the trust estate**, the **assessable income of the beneficiary (who pays income tax in this case)** shall include **that share of the net income of the trust estate**.

Net income of a trust	Under s95(1) ITAA36 , the net income of a trust is the total assessable income of the trust estate calculated under the tax law as if the trustee were a resident, less allowable deductions. It includes capital gains made by the trust.
Income of the trust estate	Income of the trust estate is not defined in the tax law. If not defined in the trust deed, it may refer to the general concept of trust income under trust law, which excludes statutory income like capital items.
Share	Two interpretations exist: <ul style="list-style-type: none"> • Proportionate view: refers to the percentage/proportion of trust income • Quantum view: means the amount of trust income. <p>According to FCT v Bamford, in relation to "share", the proportionate view rather than the quantum view is adopted.</p>
Presently entitled	- According to Harmer v FCT , a beneficiary is presently entitled if: <ol style="list-style-type: none"> a) The beneficiary has an interest in the income which is both vested in interest and vested

	<p>in possession, i.e. the beneficiary has a legal right to the money held in the trust; AND</p> <p>b) The beneficiary has a present legal right to demand and receive payment of the income, whether or not the precise entitlement can be ascertained before the end of the relevant income year and whether or not the trustee has funds available for immediate payment</p> <p>- Beneficiaries can be presently entitled to trust income even if they have no knowledge of the distribution: <i>Vegners v FCT</i>.</p> <p>- A beneficiary under a DISCRETIONARY TRUST is NOT presently entitled until the trustee exercises its discretion in the beneficiary's favour.</p> <p>- Under s101 ITAA36, once a trustee of a DISCRETIONARY TRUST has resolved to exercise its discretion in favour of a beneficiary, that beneficiary is deemed to be presently entitled to the amount paid or applied to him or her.</p> <p>- Under s95A(2) ITAA36, where a beneficiary has a vested and indefeasible interest in any of the income of a trust estate but is NOT presently entitled to that income, the beneficiary shall be deemed to be presently entitled to that income.</p>
Legal Disability	<p>Beneficiaries who cannot give a valid discharge to the trustee in respect of payments made to them.</p> <ul style="list-style-type: none"> • Minors • Undischarged bankrupts • Intellectually impaired persons

● **(CHOOSE) Beneficiary is PRESENTLY ENTITLED to the trust income but IS under a legal disability**

- Under **s98 ITAA36**, the trustee will be required to pay income tax on the beneficiary's behalf at the rate of tax that the beneficiary would have paid.
- The amount of income tax is calculated as if the share of the net income was the only income of the beneficiary and **NO deductions are available**.
- If the beneficiary derives other income, the total income is computed (calculated) and the beneficiary is taxed on the total.
- The beneficiary is entitled to a deduction for the tax paid by the trustee: **s100(2) ITAA36**.

● **(CHOOSE) NO beneficiary is PRESENTLY ENTITLED to the trust income**

- All or part of the net income that is not included in the AY of the beneficiary (**s97**) or the trustee (**s98**) will be taxed in the hands of the trustee at a penalty rate of the top marginal individual tax rate plus Medicare levy: **s99A ITAA36**.

○ **EXCEPTION**

- If the trust resulted from a will (i.e. **Testamentary trust**) and if the Commissioner opines that it is unreasonable to apply the penalty rate, the trustee will be taxed on that share of net income at the normal individual progressive tax rates: **s99 ITAA36**.

● **(CHOOSE) Minor beneficiaries**

- The tax law has a specific anti-avoidance provision designed to deal with the splitting of income from a high-income earner (e.g. father) to his children under 18 through a trust: **s102 ITAA36**. In this case, the trustee will be taxed on the net income of a minor beneficiary.
- Income of minors, including distributions from trusts, are in general taxed at the top marginal rate plus Medicare levy: **Div 6AA ITAA36**.
- Rates for 2018-19 resident minor beneficiaries

Income Amt.	Tax rate
0 - \$416	Nil
\$417 - \$1,307	66% of the excess over \$416
\$1,308 +	45% of the total Division 6AA income

- Minors in full time employment and disabled children are exempt from **Div 6AA: s102AC(2) ITAA36**.
- Employment income and income from deceased estates are exempt from penal rates: **s102AE(2) ITAA36**.

● (CHOOSE) Non-resident beneficiaries

- if a non-resident beneficiary is presently entitled to a share of the trust income and is not under a legal disability, the share of the net income (excluding foreign sourced income) is taxed in the hands of the trustee at non-resident rates: **s98(2A)** and **s98(3) ITAA36**.

Character of income preserved

- The character of an item of income is preserved when it is distributed to a beneficiary
- E.g.
 - If **dividends** received by a trust are distributed to a beneficiary, the amount remains as dividends in the hands of the beneficiary and the imputation credits can be attached to the distribution: **s207-35 ITAA97**.
 - The dividends are grossed up to determine the net income of the trust estate by the value of the imputation credit.
 - When the dividend income is distributed to the beneficiaries, the beneficiary can claim the imputation credit attached to the dividend as an offset in his or her individual tax return.
 - If the trust is in loss, the dividend income cannot be distributed and the tax offsets are lost.
 - A capital gain derived by the trust can be distributed to an individual beneficiary who may be eligible to claim 50% discount on the capital gains: **Div 115 ITAA97** (esp **115-C**).
 - If a trust makes a capital gain on the realisation of a trust asset, the capital gain can be distributed to a specific beneficiary and the 50% discount for the individual may be

claimed, provided among other things the trust has held the asset for more than 12 months.

- According to **s115-10 ITAA97**, the 50% discount applies to the trust and the trust would include a discounted capital gain in its net trust income calculation. When the trust distributes the capital gain to an individual beneficiary, the gain is grossed up to its non-discount amount and the individual (if eligible) then claims the 50% discount in his or her own tax return. The trustee needs to ensure that the capital gain is identified in the accounts of the trust and that the specific distribution is clearly identified in the distribution process.

CGT Events for Trusts

- CGT Event E1 (**s104-55 ITAA97**) □ Creating a trust over a CGT asset
- CGT Event E2 (**s104-60 ITAA97**) □ transferring a CGT asset to a trust
- CGT Event E3 (**s104-65 ITAA97**) □ converting a trust to a unit trust
- CGT Event E4 (**s104-70 ITAA97**) □ Capital payment for trust interest
 - Occurs if a beneficiary (unit holder) received a **non-assessable payment** from the trustee of a unit trust (NOT discretionary trust under **TD2003/28**) with respect of his/her interest in the trust, and the non-assessable payment is not regarded as assessable income in the hands of the beneficiary
 - E.g. distribution of certain exempt income derived by a unit trust to its unit holders
 - The time of the event is inter alia the time just before the end of the income year in which the trustee makes the non-assessable payment
 - If **non-assessable payment < cost base of the units** □ cost base and reduced cost base of the units are reduced by the amount of the payment
 - If **non-assessable payment > cost base of the units** □ cost base and reduced cost base are reduced to 0, and the excess of the non-assessable payment over the cost base is the capital gain and may be eligible for CGT discount.
- CGT Event E5 (**s104-75 ITAA97**) □ Beneficiary becoming entitled to a trust asset