Bamford, streaming and UPEs: Trust Deed reviews.

The popularity of trusts has resulted in changes to the taxation laws, and challenges by the Australian Taxation Office (**ATO**) to taxpayers' interpretation of those laws.

An example of this is the Bamford case which has had far reaching impacts on the interpretation of, and changes to, the law. While these changes represent some challenges with discretionary trusts, they are still very useful tools, provided they are managed in a comprehensive, timely and consistent way.

If a trust deed has not been reviewed recently, it is recommend to do so to make sure that the trust deed is up to scratch and it can do what you want it to do.

The Bamford decision

Section 97(1) of the *Income Tax Assessment Act 1936* (**ITAA36**) provides that where a beneficiary of a trust estate who is not under a legal disability is presently entitled to a share of the income of the trust estate, their assessable income will include so much of that share of the net income of the trust estate.

In 2010, the meaning of these terms was considered by the High Court. Mr and Mrs Bamford were beneficiaries of a discretionary trust the distributions from which were made not in fixed proportions of the income of the trust estate, but rather in fixed amounts to some beneficiaries, with a residual amount to another beneficiary. However, in determining the net income of the trust estate for the purposes of s97(1), the trustee mistakenly treated certain expenses as allowable deductions. The result of this was that the net income of the trust estate was somewhat higher than the trustee had considered it to be when initially making the distributions.

The Bamfords argued that where there was a disparity between the net income of the trust estate and the distributable income, each beneficiary's share of the net income ought to have been calculated in accordance with the terms of the distribution made under the deed, which in this case would have meant that the bulk of the increase would have gone to the beneficiary entitled to the residual amount. The Commissioner, on the other hand, calculated the ratio which the actual distributions bore to the distributable income, and then applied that ratio to the excess of net income over the distributable income, which resulted in the Bamfords being assessable on a large portion of the increase.

The High Court preferred the Commissioner's approach (which is referred to as the "proportionate approach"). Unfortunately for the Bamfords, this meant not only that they were taxed on income which they didn't actually receive, but that the trust income flowed in ways not expected by the trustee.

The Bamford decision is also authority for the proposition that a trust deed could allow a trustee to include amounts in the 'income of the trust estate' which were not "income according to ordinary concepts", but rather "statutory income", in this case a net capital gain.

Bamford amendments to trust deeds

A well drafted trust deed that allows a trustee to define the income of the trust will give a trustee more control in determining the tax outcomes of the beneficiaries. Without such provisions in a trust deed, trustees might find their power to manage the flow of distributions from the trust severely constrained.

Also, a trust deed which does not confer a power to treat a net capital gain as "income of a trust estate" on a trustee may result in the trustee being taxed at the highest marginal rate under s99A ITAA36.

Streaming

The *Tax Laws Amendment (2011 Measures No. 5) Act 2011* (effective from 29 June 2011) sup-ports "streaming" of specific capital gains and franked distributions to specific beneficiaries of a family trust, and taxing capital gains and franked distributions to which no beneficiary is "specifically entitled" in the same way as the other income of that family trust.

The Full Federal Court in Cajkusic and Bamford supports an approach to match the tax liabil-ity of a beneficiary with the income of the family trust distributed to such beneficiary.

If there is no streaming of taxable and discounted components of capital gains, and the taxa-ble net income of a trust (which includes taxable net capital gains) exceeds the trust distribut-able income, the assessable income of a beneficiary could be more or less than the amount received from that trust by such beneficiary.

Unpaid present entitlements to companies

It is also important to ensure that the trust deed does not deem any unpaid present entitlements to be loans. It is not uncommon to find a clause that states that any unpaid amounts constitute loans.

Under Taxation Ruling 2010/3, most unpaid present entitlements arising after 16 December 2009 constitute loans by the beneficiaries back to the trust. However, there is some grandfathering for those that emerged prior to this date.

If the trust deed states that any unpaid present entitlements constitute loans, it is unlikely they will benefit from the grandfathering arrangements. Where a corporate beneficiary is the subject of the unpaid present entitlement, there may be retrospective Division 7A consequences for the trust.

How expenses are to be treated

We generally take the view that it is better to have a deed that gives the trustee discretion to make distributions from gross income before deducting expenses.

Recommended issues for trust deed reviews

In our view, it is necessary for a trust deed to be reviewed to consider not just Bamford issues but also the following:

- Whether the deed has a flexible income clause that allows the trustee to decide how to calculate the trust income for section 97 purposes.
- Whether the deed has sufficient clauses to appoint income or capital of any class when appointing the income of the Trust Fund to the Beneficiaries.
- If income is defined to be equal to section 95 net income, then there is a risk, as illustrated in draft taxation ruling TR 2012/D1, that irregular outcomes can arise especially where notional income amounts like franking credits are involved.

- Many older trusts have no clause to define "income". This can be a problem for many common transactions. For example, if the trustee sells an asset and crystallises a capital gain yet has no other income, the capital gain would not form part of the income of the trust and could not be distributed to beneficiaries. Generally, when there is no income to distribute, any taxable income (in this case, capital gains) is taxed at punitive rates in the hands of the trustee.
- Consider if the trustee has the ability to distribute gross income before deducting expenses.
- The trust deed should not require the trustee to distribute income by 30 June in any year given the strict approach the ATO has indicated it will take on this issue.
- It is important to carefully check the variation clause to ensure any changes that may need to be made are permitted and also to ensure that the power to make future changes is not unduly limited. E.g. the problem in Jenkins v. Ellett was that the court construed the variation clause as limiting the trustees to a power to vary the "trusts" declared by the document and not the administrative provisions or schedule items.
- The trust itself may be near the end of its useful life – especially given that many older trust deeds have very specific, shorter "Perpetuity periods" that are often much less than 80 years.
- Does the trust deed give the trustee the power to set aside an amount distributed to a beneficiary in a separate sub-trust for their sole benefit?
- Does the deed deem any unpaid present entitlements to be loans? If so, the deed requires amendment to change this.

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