DISCRETIONARY TRUST DISTRIBUTIONS
2009-10

1. INTRODUCTION

2. WHAT HAPPENED IN 2009-10?

3. WHAT DOES THE TRUST DEED SAY?

4. DIVISION 6 AND DISCRETIONARY TRUSTS

5. CGT AND DISCRETIONARY TRUSTS

6. PARTICULAR KINDS OF TRUST

7. “INCOME” CONSIDERATIONS

8. BENEFICIARY CONSIDERATIONS

9. MAKING THE DISTRIBUTION
CHAPTER 8

BENEFICIARY CONSIDERATIONS

Context ........................................... ¶8-100
Checking the beneficiary categories ....................... ¶8-120
Minors as beneficiaries .................................. ¶8-140
Companies as beneficiaries ................................ ¶8-180
Trusts as beneficiaries .................................. ¶8-300
Exempt entities as beneficiaries .......................... ¶8-420
Non-residents as beneficiaries ............................ ¶8-480
How distributions may affect the operation of the income tax law ........................................... ¶8-500
Accumulation of income .................................. ¶8-520

¶8-100  Context
When deciding how the income of a discretionary trust for an accounting period should be distributed, a range of matters (usually involving taxation matters) will need to be taken into account. It must not be overlooked that, in some circumstances, it may be advantageous for income to be accumulated, rather than distributed (¶8-520).

It is, of course, fundamental to determine the individuals or entities to whom or to which distributions are permitted by the trust deed (¶8-120). In addition, particular issues may need to be taken into account in relation to a specific kind of beneficiary, for example, where the prospective beneficiary is an individual who is a minor (¶8-140), is tax-exempt (¶8-420), is a company (¶8-180), is the trustee of a trust (¶8-300), or is a non-resident (¶8-480). Also, if the trustee of a discretionary trust has made a family trust election or an interposed entity election, family trust distribution tax issues will need to be considered in relation to any distribution (¶6-260).

It must not be overlooked that, when making distributions, there will be situations where regard will need to be had to the way particular provisions of the income tax law operate. For example, where a pattern of distributions test needs to be met or a distribution has to be made to ensure that an individual is a significant individual in, or a CGT concession stakeholder of, the discretionary trust, this will affect the making of distributions. For a list of these provisions, see ¶8-500.

Although discretionary trusts may not have beneficiaries in the technical sense (Cypjayne Pty Ltd v Sverre Rodskog [2009] NSWSC 301), the term “beneficiaries” is used for convenience to cover the objects in whose favour the trustee of a discretionary trust may exercise the discretion to distribute income or capital.

¶8-120  Checking the beneficiary categories
An important and seemingly obvious consideration (but one which is sometimes overlooked) is to ensure that a particular individual or entity is in fact a beneficiary of the discretionary trust. The more significant matters that are relevant when determining
whether an individual or other entity is within the beneficiary class (as defined in the trust deed) include the following:

- under some discretionary trust deeds, the class of income beneficiaries is not the same as the class of capital beneficiaries;
- sometimes an event (such as a birth or death, a marriage or divorce, the incorporation of a company or a change in shareholdings in a company) may expand or contract the beneficiary class;
- even if an individual or other entity falls within the wording of the beneficiary class, the individual or entity may have disclaimed (or exercised rights under the trust instrument to forfeit benefits), with the result that no distribution may be made to the individual or other entity;
- there may have been beneficiaries added to the beneficiary class, either as a result of an amendment to the trust deed or by the trustee exercising some particular power in that regard (sometimes subject to the approval of the appointor or guardian);
- in some trust instruments, there are interpretative provisions which may affect the beneficiary class, for example, the beneficiary class may refer to a particular individual and that individual’s spouse and there may be a definition of “spouse”;
- it is usually expressly provided in the trust deed that an individual, a company or a trust may fall within the beneficiary class whether or not born or in existence at the date of the trust deed. Unless the trust deed contains a contrary intention, it would seem that the absence of such a provision should not of itself mean that an individual born, or a company or trust coming into existence, after the date of the trust deed would not qualify as a beneficiary if otherwise within a description of the beneficiary class; and
- there are usually some individuals or entities who or which are expressly excluded from the beneficiary class, for example, the settlor and, in some cases, the trustee.

Sometimes the beneficiary categories are not clearly defined in a trust deed, and in other cases, there is overlapping which is likely to give rise to issues of construction. To take a straightforward illustration of overlapping, consider the following beneficiary class:

1. John Ronald Brown;
2. Robyn Patricia Brown;
3. any children of John Ronald Brown;
4. the children and remoter lineal descendants of John Ronald Brown;
5. any grandchild or lineal descendants of John Ronald Brown; and
6. the spouse for the time being of any of the foregoing persons.

Just what categories (3) and (5) could add to category (4) is a mystery.
Minors as beneficiaries

Context .................................. ¶8-140
The unearned income rules .......................... ¶8-160

¶8-140 Context
Minors (that is, individuals who are under 18 years of age) frequently fall within the beneficiary class of a discretionary trust. However, in the case of an inter vivos trust, the potential for income splitting by distributing income to minors is often severely limited by the rates of tax that apply to the “unearned income” of certain minors.

¶8-160 The unearned income rules
The following is a very broad description of some key aspects of the special rules that apply to the unearned income of minors.

Individuals affected
The unearned income rules potentially apply to an individual who is a “prescribed person” in relation to the income year.

An individual is a prescribed person in relation to an income year if he or she is under 18 years of age on the last day of the income year and is not an “excepted person” (sec 102AC ITAA 1936). A minor will be an excepted person in relation to an income year (so that the unearned income rules will not apply) if he or she:

1. was engaged in a full-time occupation on the last day of the income year and the Commissioner is satisfied that he or she had the intention of engaging in a full-time occupation during the whole or a substantial part of the next succeeding income year and did not have the intention of engaging in a course of full-time education at a school, college, university or similar institution at any time during the next succeeding income year; or
2. falls within one or other specified categories in the Social Security Act 1991 (Cth) (sec 102AC(1), (2) and (8) ITAA 1936).

For the purposes of (1) above, the fact that a minor is not engaged in a full-time occupation on the last day of the income year will not necessarily mean that he or she will fail the full-time occupation test. The test will be met (subject to the Commissioner being duly satisfied in relation to the next income year as required by (1) above) if the minor was engaged in a full-time occupation during the income year for a period of (or for periods that in aggregate total) at least three months (sec 102AC(6) ITAA 1936). Any period of full-time occupation during the income year that preceded being engaged in a course of full-time education at a school, college, university or similar institution is ignored.

Trust income
In the context of a trust, the unearned income rules apply to so much of a prescribed person’s share of the net tax income of the trust for the income year as the Commissioner
considers is attributable to assessable income of the trust that is not, in relation to the person, excepted trust income (sec 102AG(1) ITAA 1936).

**Non-arm’s length income**
Where two or more parties to the derivation of excepted trust income or to or any act or transaction directly or indirectly connected with the derivation of excepted trust income, were not dealing with each other at arm’s length, the excepted trust income is only so much (if any) of that income as would have been derived if they had been dealing with each other at arm’s length (sec 102AG(3) ITAA 1936).

**Agreement to secure excepted trust income status**
Assessable income that is derived by a trustee directly or indirectly under or as a result of an agreement that was entered into or carried out by any person for the purpose (or for purposes that included the purpose) of securing that that assessable income would be excepted trust income, is not excepted trust income (sec 102AG(4) ITAA 1936). For this purpose, no regard is had to a purpose that is a merely incidental purpose (sec 102AG(5) ITAA 1936).

**Trusts not affected**
The kinds of trust that most frequently derive excepted trust income (which falls outside the unearned income rules) are:

- testamentary trusts (¶6-120); and
- child maintenance trusts (¶6-200).

Apart from these categories of trusts, the broad position is that, for trust income to be excepted trust income, the income must be derived from certain compensation and similar receipts.

**The rates**
The special rates of tax payable on so much of the taxable income of a minor as is eligible taxable income commence to apply where the minor’s eligible taxable income exceeds $416. Where a resident minor’s only taxable income is eligible taxable income, the effect of the special rates of tax and the low income offset is that no tax is payable if the eligible taxable income is $3,000 or less.

**Companies as beneficiaries**
Context .......................... ¶8-180
Issues to consider .................. ¶8-200
The beneficiary class description .. ¶8-220
Div 7A issues ........................ ¶8-240
Losses .............................. ¶8-260
Structure of company ............... ¶8-280

¶8-180  Context
The potential beneficiary class under a typical discretionary trust deed will extend to companies that are either expressly named or are generically described.

The attraction of distributing income to a corporate beneficiary usually lies in the company rate of tax (currently 30%) and the fact that a company is not required to make any minimum level of distribution. However, there are a number of issues that need to be taken into account in relation to the distribution of income by a discretionary trust to a company (¶8-200).

¶8-200 Issues to consider
The following significant issues should be considered when contemplating the distribution of income of a discretionary trust to a company (otherwise than in the capacity of a trustee):

whether the company falls within the beneficiary class (¶8-220);
what use is to be made of the company’s entitlement to income, particularly having regard to Div 7A ITAA 1936, for example, if the amount to be distributed (or any part of it) is to remain with the trust, any possible implications that may arise from the operation of that Division must be considered (¶8-240);
if the company has unrecouped ordinary income or capital losses or a current year income or capital loss, whether these will be able to be offset against the distribution (¶8-260);
if the trust has a net capital gain which includes a capital gain that has been reduced under the CGT discount capital gain concession, the effect of the discount will be reversed for a company beneficiary to the extent that the company is assessed on any part of the reduced capital gain because companies do not get the benefit of the CGT discount capital gain concession (¶5-220); and
whether the structure of the company is such that the benefit of the distribution will eventually be able to be obtained by the persons who are ultimately intended to benefit (¶8-280).

¶8-220 The beneficiary class description
If a particular company is named as a beneficiary in the trust deed, then, of course, no difficulty would arise, unless the company has for some reason ceased to be a beneficiary. More usually, the beneficiary class of a typical discretionary trust contains a generic description of the companies that may fall within the class. A wide variety of descriptions will be encountered in practice and several examples with brief comments are set out below. These comments assume that there are no interpretative provisions of the trust deed that are relevant.

Whether a company satisfies the particular beneficiary description in a trust instrument would need to be determined at the time when the distribution is in fact made.

Example 1
“a corporation in which any of the shares are beneficially owned by any of the Principal Beneficiaries or the Secondary Beneficiaries”
Comment
This description fastens onto the identity of the beneficial owners of the shares in the company (at the time it is necessary to determine beneficiary status), rather than on the identity of the shareholders. Accordingly, the share register will be relevant but not conclusive.

The concept of beneficial ownership can raise difficult issues. Where a share is held by a nominee, say, for an individual in his or her own right, the individual would clearly be the beneficial owner of the share. If, however, the shareholder held the share as the trustee of a discretionary trust, there would be no beneficial owner of the share, unless the context of the particular trust instrument supported the view that the expression “beneficial owner” had a meaning that is wider than its normal meaning. There will be different factual situations that fall within these two extremes.

This beneficiary class refers to “any of the shares” and, accordingly, if there are different classes of shares on issue, it would not matter which class of share a beneficiary beneficially owned.

Example 2
“any company in which a Principal Beneficiary or a Secondary Beneficiary or the trustee of an Eligible Trust is a shareholder”
or
“any company in which a share is held for the time being by any of the Beneficiaries referred to in the preceding paragraphs”

Comment
In the ordinary meaning of the word “shareholder”, a person will be a shareholder of a company at a particular time if the person’s name is entered on the share register at that time or if the person is entitled as against the company to have their name entered on the share register (typically a transferee under a share transfer, the registration of which has been approved by the directors) and whose name is subsequently entered on the register from that time (FCT v Patcorp Investments Ltd [1976] HCA 67; 76 ATC 4225).

Subject to a contrary intention in the trust deed, these beneficiary descriptions merely require an examination of the share register of the company at the time beneficiary status is being determined, and of any approved share transfer that may be awaiting registration at that time. The fact that a share may be held on trust (even a bare trust) would be irrelevant; all that would be relevant is the identity of the shareholder.

Under these beneficiary classes, it would not matter what class of share a relevant beneficiary held.

Example 3
“any company owned or controlled by any Beneficiary”

Comment
This beneficiary description (which would need to be applied at the time beneficiary status is being determined) raises some issues. What constitutes “control” of a company for this purpose will depend on the context of the trust deed. One possible meaning is the meaning that has been given to the expression in revenue cases, such as Mendes v Commissioner of Probate Duties (Vic) ([1967] HCA 23; 122 CLR 152). The effect of these cases is that a shareholder controls a company if the shareholder holds enough shares to give a majority of votes at a general meeting in relation to all matters able to be dealt with at a general meeting (except, perhaps, as to minor or incidental matters). On this meaning of control, the powers conferred on the directors would be irrelevant.

However, there may be other circumstances in which a beneficiary could control a company in the relevant sense. For instance, where an individual is the permanent governing director of a company under the company’s constitution, could it be said that the individual controlled the company?

There are also issues as to whether indirect control would be relevant for this beneficiary class.

What is meant in this beneficiary description by a company being “owned” by a beneficiary is not clear. It would seem that the word “owned” is used in a popular sense, rather than in a technical sense. A beneficiary who beneficially held all of the shares in a company could be said to own the company in such a sense, but such a beneficiary would also control the company. The circumstances in which it could be said that a company was “owned” by a beneficiary where the beneficiary did not “control” the company is not clear.

This beneficiary description refers to a company which is owned or controlled by “any beneficiary”. Where one beneficiary does not control a company but two or more beneficiaries could be said to do so (for example, where there are two equal beneficial shareholders in a company and both are beneficiaries), the question will arise as to whether the singular (“any beneficiary”) includes the plural — either because of a provision in the discretionary trust deed or of a statutory provision (for example, sec 181 of the Conveyancing Act 1919 (NSW)).

Example 4
“any corporation of which any Beneficiary is a director, shareholder or beneficial owner of a share in the capital of such a corporation”

Comment
This beneficiary class covers not only the situation where a share is held by a beneficiary, but also the situation where a beneficiary beneficially owns a share. It further extends to a company in which a beneficiary is a director.
Example 5
“any company (whether in existence at the date of this deed or not) of which any of the Beneficiaries in the preceding sub-clauses is or has been a shareholder”

Comment
Under this beneficiary class, once a company qualifies as a beneficiary (because at some time a beneficiary has been a shareholder), the company thereafter remains a beneficiary. For the concept of “shareholder”, see the comment to Example 2 above.

¶8-240 Div 7A issues
When contemplating the distribution of income by a discretionary trust to a corporate beneficiary, it is necessary to consider what possible operation the provisions of Div 7A ITAA 1936 (payments to, loans to and forgivenesses of debts owed by shareholders and associates of shareholders of private companies) may have.

If a company is made presently entitled to a share of the income of a discretionary trust for an income year, it will, of course, be assessed on “that share” of the net tax income (¶4-360). However, it is the company’s share of the income of the trust estate that will be relevant in any consideration of the possible operation of Div 7A ITAA 1936 since that goes into the calculation of the company’s distributable surplus.

Of most concern will be the possible operation of the provisions of Div 7A ITAA 1936 because of the following:

(1) if the company makes a loan (as defined for the purposes of Div 7A ITAA 1936 (see below)) to the trust in respect of the distribution, it is likely that the company loan rules in Div 7A ITAA 1936 may be potentially applicable because it would usually be the case that the discretionary trust would be an “associate” (as broadly defined) of a shareholder of the private company. If the company loan rules in Div 7A ITAA 1936 are applicable, the company will be taken to have paid a deemed dividend to the trust, unless: