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# Alternative investment vehicles

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# Introduction

## Synopsis

As we know, SMSFs are common tools for accumulating wealth during working years and distributing those funds post retirement. However, with recent changes to contribution caps, increased complexity as to the management of SMSFs and restrictions on access to those funds pre-retirement, are there more suitable investment opportunities individuals should consider?

In this paper we will explore alternative structures to superannuation funds. Consideration will be given to the **asset protection**, **taxation** and **flexibility** elements of structures.

This paper is intended to be practical whilst still addressing technical issues. Not all of the detail in these materials will be covered during the presentation.

In these materials **ITAA 36** is a reference to the Income Tax Assessment Act 1936 and **ITAA 97** is a reference to the Income Tax Assessment Act 1997.

## Choosing an alternative investment structure

### A non-exhaustive checklist

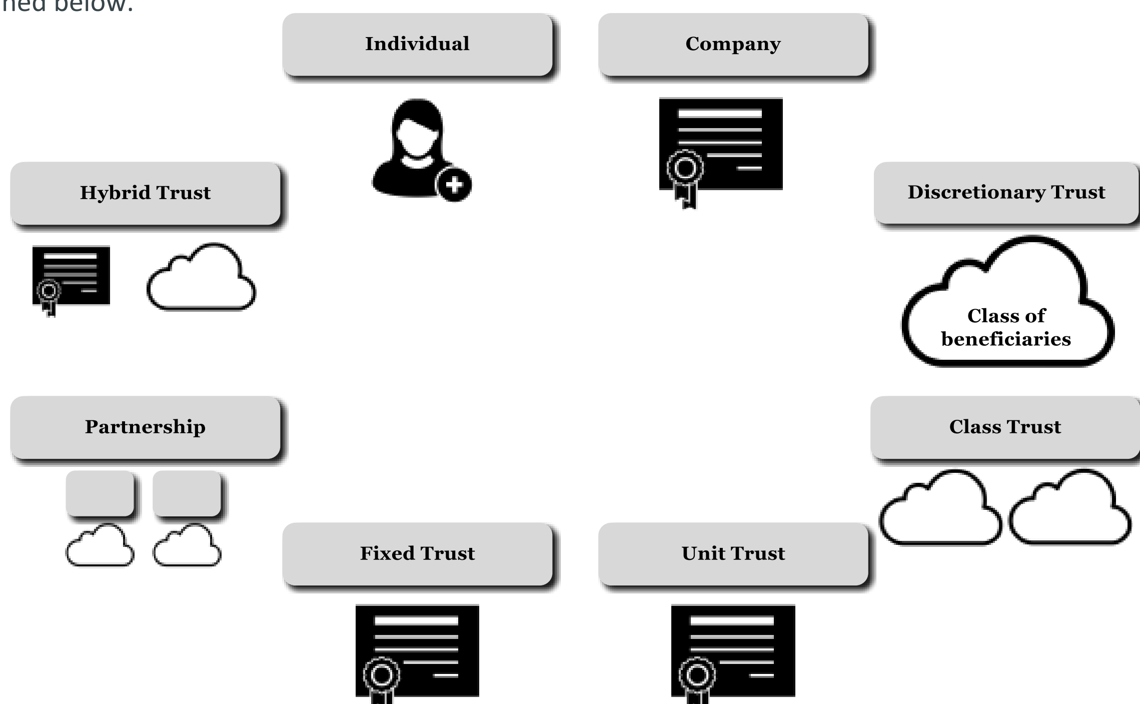
There is no simple template or "off-the-shelf" solution for structure choice for investment structure alternatives to self managed superannuation funds. In choosing an alternative structure for an investment (or operating a business) requires a consideration of a large range of issues including:

- the ability to isolate assets from risks such as:
  - claims of creditors of a business;
  - insolvent trading risks of directors and group companies;
  - directors' liabilities in respect of both insolvent trading and tax;
  - exposure to claims in relation to environmental issues, industrial matters, product liability or negligence;
  - claims that are not sufficiently protected by insurance or where insurance liability is not admitted — for example, claims involving public risk and professional indemnity issues;
  - exposure of assets to claims by spouses (including de facto spouses) following the failure of relationships and risks relating to court jurisdiction over disputed assets;
  - cross liabilities through the provision of loans and guarantees;
- who should hold and have access to voting rights, income and capital rights and capital growth rights;
- availability of offsetting start up losses against future taxable income;
- aggregation and grouping issues;
- the ability to distribute the income of the structure amongst a wide range of beneficiaries;
- the establishment costs of the structure;
- the management and control of the structure;
- the administrative simplicity and cost efficiency of the structure;

- the regulatory requirements of operating a business through the structure; the ability to transfer interests between participants in the structure;
- the ability to introduce additional investors into the structure in the future;
- the ability to offer investment opportunities to the public at large (including how general Corporations Act 2001 (Cth) issues and more specific managed investment scheme issues may be relevant);
- the implications in respect of both stamp duty and the goods and services tax (GST) relating to transactions both within and external to the structure, and any restructuring that may be necessary in the future;
- the ability to prepare the structure and costs, and implications of reorganising the structure to enable it to be listed on the Australian Stock Exchange;
- the CGT issues relevant to the structure, including issues relating to the disposal of assets by the structure and the disposal of interests in the structure;
- the applicable rate of tax payable by the entities involved in the structure;
- the payroll tax and WorkCover liabilities associated with a particular structure;
- the application of specific taxation rules such as the alienation of personal services income measures, the provisions of Division 7A Income Tax Assessment Act 1936 which treat certain loans and payments as unfranked dividends and provisions dealing with the ability to offset income against losses (ie negative gearing);
- the ability to access various concessions available under the income tax legislation in addition to those relating to CGT, such as research and development concessions;
- the ability to pay superannuation contributions from the structure;
- the GST issues in respect of both registration for the tax system and also the timing of tax periods for the entities involved in the structure, their ability to group and their requirement to comply with the PAYG measures.

## Structure options

The answers to those questions above (and others) will determine which of a myriad of structure options is the most appropriate for any particular circumstance. Some of the structure options to be considered in this paper are outlined below.



# Why discretionary trusts?

The key benefits of using a discretionary trust for investment purposes, are:

## Asset protection and succession planning

Taxpayers will typically establish a discretionary trust (with a corporate trustee) to diversify risk and manage wealth to protect against trustees in bankruptcy. The separation of legal and beneficial ownership is unique characteristic of trusts that provides greater asset protection as compared to a private company.

## Distribution flexibility

Discretionary Trusts fundamentally permit the trustee to determine among a wide class of beneficiaries who is entitled to the annual income and who can benefit from capital. Distributions are not treated as dividends which are subject to strict rules under the Corporations Act 2001, and wealth can be distributed among a family in a flexible and tax effective way.

## Capital Gains Tax 50% discount on assets held for more than 12 months

Taxpayers also establish discretionary trusts to hold capital appreciating assets to avail of the 50% CGT Discount on sale (an attribute not available to a company). Separating the operation of the business (typically undertaken in a company) from the assets used in the business, such as land (typically held by a discretionary trust) has been widely accepted as a sensible commercial practice.[1]

It could hardly be argued that an advantage sought to be exploited by adopters of discretionary trusts is the ability to “fly under the radar” or engage is questionable practices to hide wealth or engage in tax evasion. Arguably such considerations are not at the forefront of the majority of taxpayers’ minds.

Taking the above considerations into account and having regard to the lack of a legislative agenda under the current government to alter the tax treatment of discretionary trusts, the future use of discretionary trusts in Australia is unlikely to alter significantly.

The proposed amendments to Division 7A (discussed below), and the potential expansion of including UPEs within the meaning of a loan under s 109D of the ITAA 36 (discussed below), may impact of structures which taxpayers adopt. However, it is very difficult to predict how the reformed Division 7A will operate in light of the divergences between the original Board of Tax Paper in 2014, and the Treasury Consultation Paper released in 2018.

[1] Note also that the Small Business CGT Concessions, and particularly s 152-10(1A) and 152-10(1B), recognise this structure and provide taxpayers with the ability to avail of the Small Business CGT Concessions.

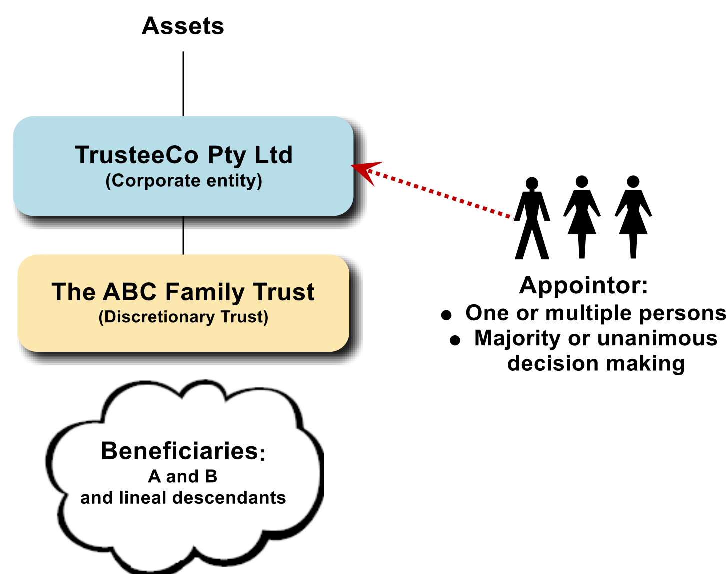
# Understanding the key elements of a modern trust

## What is a trust?

A trust is a relationship. It is not a separate legal entity except for some taxation purposes.

A trust has the following key elements:

- It must have trust property;
- It must have a trustee that holds the legal title to that trust property; and
- It must have beneficiaries for whom the trustee is to manage and apply the trust property.




A trust is the relationship between those three key elements outlined above. The trust deed is the legal document that defines the relationship. It identifies the beneficiaries and outlines the trustee's obligations and duties.

In addition to the three key elements outlined above a trust may also have an appointor or guardian.

## Valid establishment of a Discretionary Trust

Discretionary trusts are generally created by a person (the settlor) gifting a nominal sum (the settled sum, for example $20.00) to a natural person or company (the trustee). The settled sum is held by the trustee for the benefit of named persons or beneficiaries. The class of beneficiaries usually include the named beneficiaries' relatives and companies or trusts in which any of those persons hold shares or are beneficiaries. The settlor's gift and the trustee's acceptance of its obligations in holding and managing the trust property are acknowledged and agreed when the parties execute the trust deed. The settled sum is the initial trust property.

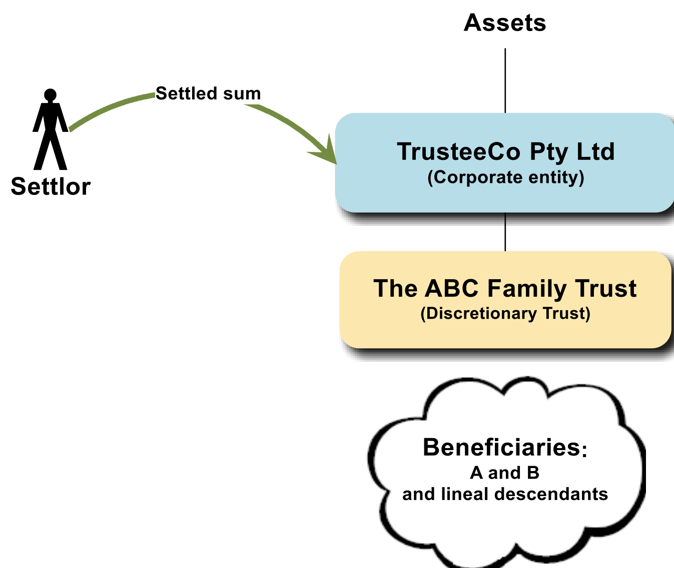
Subsequently, the trustee is able to add to the trust property by borrowing, receiving gifts or acquiring other assets

Generally, the trust deed of a discretionary trust will provide for an appointor, primary beneficiaries and general beneficiaries.

Under a discretionary trust, the trustee holds the legal title to the assets of the trust and also conducts the day to day operation of the trust (which may include the operation of a business). The trustee often has a complete discretion as to which, if any, of the beneficiaries may benefit from any of the capital or income of the trust.

The beneficiaries of a discretionary trust are mere objects of the trust. The beneficiaries do not have any enforceable rights over the assets or income of the trust but merely have a right to be considered when the trustee makes distributions.

The beneficiaries of a trust should not be related to the settlor.




Proceeding in this manner will ensure the revocable trust provisions contained in section 102 of ITAA 36 will not be available to the Commissioner to tax the trustee on any of the income of the trust on the basis the income was additional income derived by the settlor.

These principles arise from the decisions of the High Court on the potential application of section 102 of ITAA 36 in *Hobbs* and *Truesdale.*[2]

Sub-section 102(1) provides:

> Where a person has created a trust in respect of any income or property (including money) and:
>
> (a) he has power, whenever exercisable, to revoke or alter the trusts so as to acquire a beneficial interest in the income derived by the trustee during the year of income, or the property producing that income, or any part of that income or property; or
>
> (b) income is, under that trust, in the year of income, payable to or accumulated for, or applicable for the benefit of a child or children of that person who is or under the age of 18 years;
>
> the Commissioner may assess the trustee to pay income tax, under this section, and the trustee shall be liable to pay the tax so assessed.

If a person has established a trust under which that person was both the trustee and empowered to vary the trust to enable the trustee under a power of appointment to appoint the income of the trust in favour of that person, sub-section 102(1) could be applied by the Commissioner to that income.

Sub-section 102(1) will also have potential application where the income of the trust is, in a particular year of income, payable to, accumulated for or applicable for the benefit of a child or children of the settlor who is under the age of eighteen years.

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[2] *Hobbs v Federal Commissioner of Taxation* (1957) 98 CLR 151; 11 ATA 248 and *Truesdale v Federal Commissioner of Taxation* 70 ATC 4056; (1970) 120 CLR 353.

As found in *Hobbs*, the provisions of sub-section 102(1) will not be available to the Commissioner where the payment, accumulation or application of the income for the benefit of a child is subject to any contingency, for example, if the income is to be accumulated until the child who is to benefit attains twenty-five years of age.

In *Truesdale*, the High Court considered whether sub-section 102(1) could be applied by the Commissioner to gifts made to the trustee of trusts after their establishment, by the father of the infant beneficiaries. It was held the words in the sub-section "created a trust" did not "cover the making of contributions to a trust already created".[3]

The principles from *Hobbs* and *Truesdale* make it clear that any possible application of the provisions of sub-section 102(1) to a trust will be avoided where the beneficiaries of a trust are not related to the settlor.

For the reasons outlined, trust deeds will most commonly exclude the settlor from being a beneficiary.

Even if the settlor is a beneficiary, provided that person does not have power to revoke or alter the trust so as to acquire a beneficial interest in its income and income is not payable to or accumulated for or applicable for the benefit of a child or children of that person under the age of eighteen years, the Commissioner could not apply sub-section 102(1) to the income of the trust.

Generally, on the validity of the creation of a trust by a settlor, it is interesting to note the following comment of Menzies J in *Truesdale*:

> K J Ellis gave evidence that the money so paid into his account was his own and that he did not receive any refund in respect of that payment or of the cheques given by him to the appellant and debited to that account on 29 April. Neither the appellant nor JWB King was questioned about this matter and, despite some suspicion, I think I should proceed on the footing that this was so.4

No doubt in making these comments, Menzies J was referring to the efficacy of the payments made and whether the trusts under his consideration had in fact been established.

In many instances a trust will not have been effectively created because the original settlement sum or property is either not provided by the settlor from the settlor's own money or assets, or alternatively that sum is refunded to the settlor by the person whose family are to be the principal beneficiaries of the trust or another relative.

To ensure that a trust is properly created and that the persons whom it is intended benefit from the income and/or capital of the trust are both under the terms of the trust and for taxation purposes, the beneficiaries of the trust, it is imperative that the settlor provide the settlement sum from the settlor's own resources, that there be clear evidence of the payment having been made and that the settlement sum not be repaid.

## Who are the beneficiaries?

To properly and definitively determine the beneficiaries of a trust it is necessary to establish who may benefit from the trust and to what extent and how a particular benefit may be provided. It is important that these issues should be considered at the time a trust is established. Unfortunately, in most instances, they are not.

There are some issues that arise in determining the beneficiaries of a discretionary trust that should be considered.

### Notional settlor

Often trust deeds will exclude the settlor of the trust and any "notional settlor" from being a beneficiary of the trust. For example, "notional settlor" may be defined in the deed as "… someone who has made any disposition of property in favour of the trustee other than for full consideration in money or moneys' worth". The operation

[3] *Truesdale* at 4060.
[4] *Truesdale* at 4057 and 4058.

of notional settlor provisions may result in persons who had been receiving distributions of income and capital from a trust not actually being included within the class of beneficiaries of the trust.

### The trustee

A trust deed may exclude the trustee from the class of beneficiaries, unless the trustee is specifically named as a beneficiary.

### Other related beneficiaries

Some trust deeds may not specifically exclude the trustee as a beneficiary but include a provision to so exclude any company in which specific persons (for example the guardian) have any interest. In these circumstances, if the guardian named in the trust deed is a shareholder in the trustee, the trustee would be disqualified from being a beneficiary.

### Traps with multiple trusts

With many family groups now holding assets through several separate trusts, the ability to appoint income or capital between those trusts needs to be carefully considered. Simply having the same primary beneficiaries named in the schedules to both trust deeds does not mean that the trustees of both trusts may make distributions between the two trusts.

## Notional Settlor

When establishing trusts for asset protection purposes, key family members often transfer assets to the trust as gifts or at less than market value consideration. In this circumstance, the provisions of the trust deed may have the effect of excluding those family members or entities related to them as beneficiaries of the trust.

Trust deeds often exclude the settlor of the trust and, in some instances, any "notional settlor" from being a beneficiary of the trust. The notional settlor in these trusts is usually defined "as someone who has made any disposition of property in favour of the trustee other than for full consideration in money or moneys' worth"[5] As key family members often transfer assets to the trust as gifts, or at less than market value consideration, this could inadvertently result in a principal benefactor of the trust being excluded as a potential beneficiary of the trust.

The exclusion of the notional settlor usually only applies where that person is not named as a primary beneficiary. Accordingly, in these circumstances, where a beneficiary of the trust (other than a primary beneficiary) gifts their present entitlement to the trust for asset protection reasons, that person would cease to be a beneficiary.

The operation of notional settlor provisions may result in persons who had been receiving distributions of income and capital from a trust not actually being included within the class of beneficiaries of the trust.

| Case study 1 A & B: |
| --- |
| Jason is an equity partner in a professional services practice. |

[5] Mathison, Neil 'Discretionary Trusts – problems with beneficiaries' (2004) 39(4) *Taxation in Australia*.

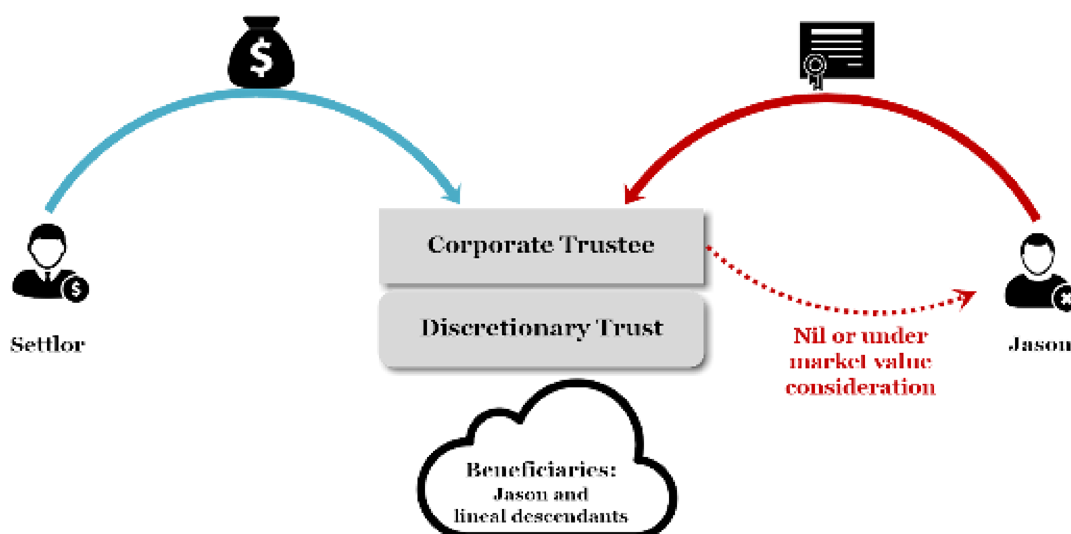
Jason has a large share portfolio in his own name and although he is not currently exposed to any actual liability and no liability is currently foreseen, Jason is concerned that at some point in the future, through no fault of his own, assets held in his own name may be exposed to claims made against Jason as a partner in the professional services practice.

Jason decides to establish a discretionary trust. After the trust has been established Jason intends to transfer his share portfolio into the trust. Jason is aware that the market value substitution rules in the ITAA 97 will apply to deem market value capital proceeds and cost base but Jason is satisfied the net position (after offsetting capital losses on some shares to the capital gains on other shares) is only a small capital gain.

Jason is not married and has no children. He intends to distribute some of the franked dividends derived on the share portfolio to himself. Jason comes to see you to assist and presents a trust deed he arranged through the accountant of one of the other partners in the professional services practice.

You notice that the trust deed Jason intends to use contains a definition of notional settlor. It provides as follows:

"'notional settlor' means any person by whom any disposition of property of any nature to or in favour of the Trustees shall be made at any time otherwise than for fully adequate consideration in money or money's worth."




**Q1. What is the significance of the trust deed containing such a definition?**

Depending on the interaction of that defined term with the clauses of the trust deed outlining and defining the class of beneficiaries of the trust, the reference to a notional settlor provision may imply that Jason, in making an undervalued gift to the trust, would be excluded as a beneficiary of that trust.

**Q2. What clauses should you carefully review?**

You should carefully review all clauses that operate to define the class of beneficiaries of the trust, including any (which may appear throughout the deed) that limit the range of individuals and entities that may be included within the class of beneficiaries based on those individuals or entities falling within specific groups such as excluded persons. Careful review of the deed should be undertaken to identify any of these excluded classes.

Specific questions that you could ask include:

- Does the definition of "general beneficiaries" in the deed provide for specific exclusions?
    - For example, a class of people described as "ineligible beneficiaries".
- Does the deed provide that a person defined as a "notional settlor" is an "ineligible beneficiary"?
- Are there any saving provisions?
    - For example, is there a provision that overrides the definition of ineligible beneficiaries to include within the class of beneficiaries the named primary or specified beneficiaries.

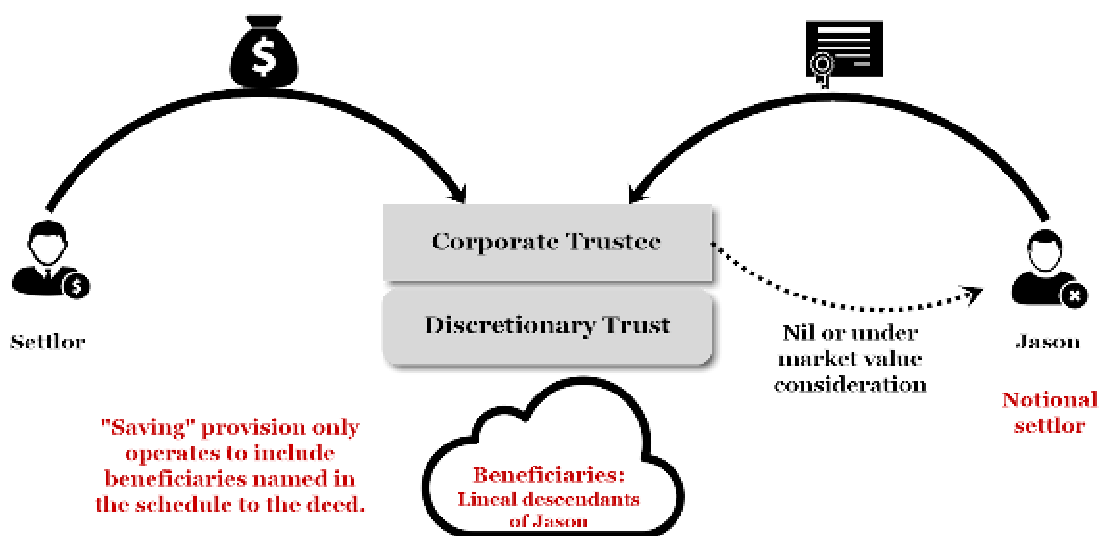
**Case study 1C:**

Continuing with the fact scenario above, Jason established the new trust not only for asset protection for the current generation but also for the purpose of protecting assets in the event of his death.

Susan operates a successful small business and is the director of the trading company. In that role she has been required to sign personal guarantees for finance obtained for the business from time to time.

Jason wants Susan to be able to control the share portfolio after his death but does not want her to own the assets outright as he is concerned that her creditors or a future spouse may try to gain access to the assets for their own benefit. Jason and Susan would prefer that the assets ultimately be available to their children.

Jason has been advised that identifying only his children as the primary beneficiaries will help to clarify the purpose for which the trust has been established and provide a further evidentiary argument against their creditors or the Family Court should the survivor of them remarry after the other's death.



**Q1. Is it safe to assume Jason will be a beneficiary of the trust even if not named as a primary beneficiary?**

No. In Case Study 1B, if Jason was excluded as a beneficiary as being a notional settlor, he falls within the group defined as “ineligible beneficiaries” which are excluded as members of the class of beneficiaries.

**Q2. What clauses should you look for to determine if Jason is a beneficiary of the trust?**

You should consider whether there is a saving provision which may operate to include Jason despite him being an “ineligible beneficiary” as a notional settlor. In this case such a provision may still be problematic as the clause often operates to ensure that persons named as primary beneficiaries in the schedule to the trust deed are not excluded as beneficiaries of the trust. In this case study Jason is not specifically named as a primary beneficiary in the schedule to the trust deed.

Therefore, a generic saving provision in the particular trust deed used for the example would not have operated to bring Jason back within the class of beneficiaries (after being excluded as a notional settlor).

**Q3. What are the implications for Susan?**

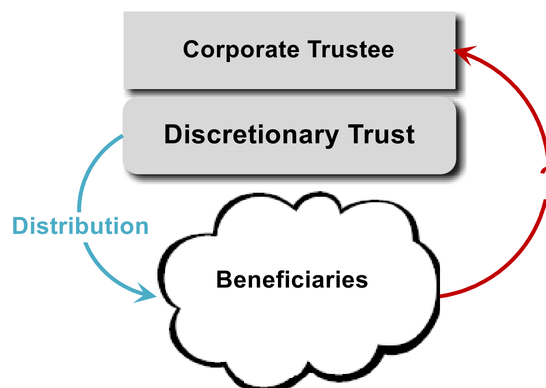
Assuming the definition of general beneficiaries of the trust deed is based the person’s relationship with the primary beneficiaries then Susan may still fall within the class of beneficiaries of the trust despite the fact that Jason is excluded.

**Q4. Are Jason and Susan’s children definitely beneficiaries of the trust?**

Not necessarily. Consider a situation where there is no saving provision but there are definitions for notional settlors, ineligible beneficiaries and exclusions from the class of beneficiaries of the deed. In that circumstance even though named in the schedule to the deed Jason and Susan’s children may be excluded as beneficiaries of the trust if they did something (such as gift assets into the trust) which resulted in them meeting the relevant definitions.

## The Trustee

In some circumstances, provisions of the relevant trust deed may provide that the trustee is excluded from the class of beneficiaries, unless the trustee is specifically named as a beneficiary.  This is often overlooked.




If it is determined to appoint a potential beneficiary of a trust to be the trustee, any provision in the proposed trust deed which excludes the trustee from being a beneficiary should be removed from the deed. Provided that the settlor of the trust was not the trustee, removing the exclusion of the trustee as a beneficiary would not

enable the Commissioner to invoke the provisions of sub-section 102(1) of ITAA 36. However, questions regarding the proper exercise of the trustee's fiduciary duties or the general anti-avoidance provisions of the income tax legislation still need to be considered prior to any such distribution. Further, any variation of the trust deed would need to be carefully drafted in order that the variation did not result in the creation of a new trust. Stamp duty implications should also be considered as some states only allow for the exemption from stamp duty on a change of trustee if the new trustee is excluded as a beneficiary.

## Other Related Beneficiaries

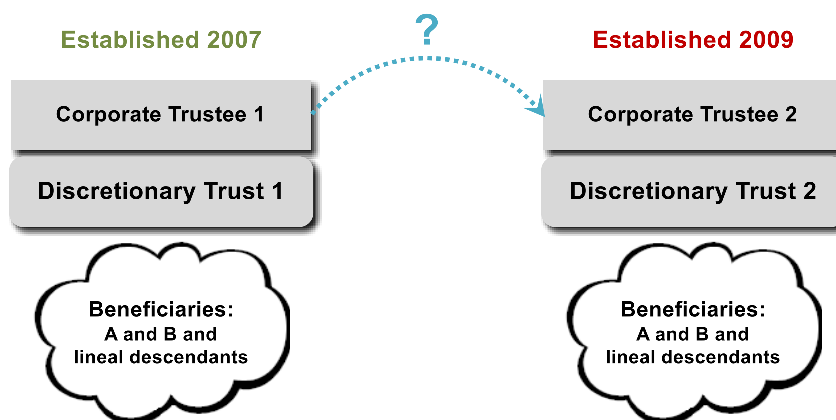
Some trust deeds may not specifically exclude the trustee as a beneficiary but include a provision to so exclude any company in which specific persons (for example the guardian) have any interest. In these circumstances, if the guardian named in the trust deed is a shareholder in the trustee, the trustee would be disqualified from being a beneficiary. It would also present a difficulty where the trustee was empowered to nominate a company as beneficiary and in the purported exercise of that power the trustee did so even though its shareholders included the guardian of the trust.

Where the only named beneficiaries are the children of a person who has arranged for the establishment of a trust, that person, immediately or in the future, may be excluded as a beneficiary.

This will occur if the person is named as any one or more of the trustee, guardian or appointor or becomes a notional settlor and the trust deed provides that unless specifically nominated as beneficiaries, persons who hold the position of trustee, guardian and/or appointor or become a notional settlor are excluded as beneficiaries of the trust.

## Traps with multiple trusts

Identification of the beneficiaries of a trust is relevant to the increasingly common occurrence of distributions of income and capital from one trust to another trust. With many family groups now holding assets through a number of separate trusts, the ability to appoint income or capital between those trusts needs to be carefully considered. Simply having the same primary beneficiaries named in the schedules to both trust deeds does not mean that the trustees of both trusts may make distributions between the two trusts. It is important to pay attention to the operation of any exclusions that apply to provisions of the trust deed that identify the class of beneficiaries.



# Perpetuity periods

Some trust deeds contain provisions that only permit the inclusion of secondary trust estates within the class of beneficiaries of the distributing trust if the vesting date of the recipient trust is no later than the perpetuity period of the distributing trust.

The common law rule known as the rule against perpetuities, as stated in *Cadell v Palmer*,[6] provides that an interest in property must vest within 21 years of the termination of a life or lives in being at the date of the creation of the interest. Failure of the property to vest within that period will mean that the interest in the property was not validly created and is void from the outset.[7]

The rule was developed in the seventeenth century as a means of restricting certain dispositions of property.[8] The rule applies to distributions of income and capital, as the rights created by a distribution constitute interests in property. In the case of distributions from one discretionary trust to another, those interests do not vest upon their creation as the trustee of a discretionary trust has a discretion to apply the income or capital to the benefit of a range of discretionary objects.

## Perpetuities legislation

The common law rule has been amended by legislation in all Australian States and Territories.[9] In South Australia the rule has actually been abolished.[10] Save for South Australia, the amendments to the common law rule generally include two aspects:

- the provision for a fixed perpetuity period; and
- the introduction of a "wait and see" rule.

In relation to the fixed perpetuity period, the Victorian legislation provides as follows:

> "…where the instrument by which any disposition is made so provides the perpetuity period applicable to the disposition under the rule against perpetuities instead of being of any other duration shall be such number of years not exceeding eighty as is specified in the instrument as the perpetuity period applicable to the disposition."[11]

Similar legislation in each State or Territory, save for South Australia, allows a trust to have a fixed perpetuity period not exceeding 80 years provided the trust provides for the fixed perpetuity period.[12]

The rule against perpetuities is particularly important in succession planning as the transfer of assets from one trust to another could result in the rule being breached.

The "wait and see" rule[13] provides that it is only when it becomes certain that the interest will not vest within the perpetuity period that the original disposition will be void. Until that time the disposition will be treated as if it were not subject to the rule against perpetuities.

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6 *Cadell v Palmer* (1883) 6 ER 956.
7 Mathison, Neil 'Trust to trust distributions and the rule against perpetuities' (2005) 39(8) *Taxation In Australia* 430.
8 Ibid.
9 Perpetuities and Accumulations Act 1985 (ACT), Property Law Act 1974 (Qld), Perpetuities Act 1984 (NSW), Law of Property Act (NT), Perpetuities and Accumulations Act 1992 (Tas), Perpetuities and Accumulations Act 1968 (Vic), Property Law Act 1969 (WA).
10 section 61 Law of Property Act 1936 (SA).
11 Subsection 5(1) Perpetuities and Accumulations Act 1968 (Vic).
12 Section 8 Perpetuities and Accumulations Act 1985 (ACT), section 209 Property Law Act 1974 (Qld), section 8 Perpetuities Act 1984 (NSW), section 187 Law of Property Act (NT), section 6 Perpetuities and Accumulations Act 1992 (Tas), section 101 Property Law Act 1969 (WA).
13 Section 9 Perpetuities and Accumulations Act 1985 (ACT), section 210 Property Law Act 1974 (Qld), section 8 Perpetuities Act 1984 (NSW), section 190 Law of Property Act (NT), section 9 Perpetuities and Accumulations Act 1992 (Tas), section 6 Perpetuities and Accumulations Act 1968 (Vic), section 103 Property Law Act 1969 (WA).

Distributions from one trust (the transferor trust) to another trust (the transferee trust) will not be void at the outset even if the transferee trust has a later vesting date than the transferor trust. Only when it becomes certain that the interest will not vest within the perpetuity period of the transferor trust will the distribution be void.[14]

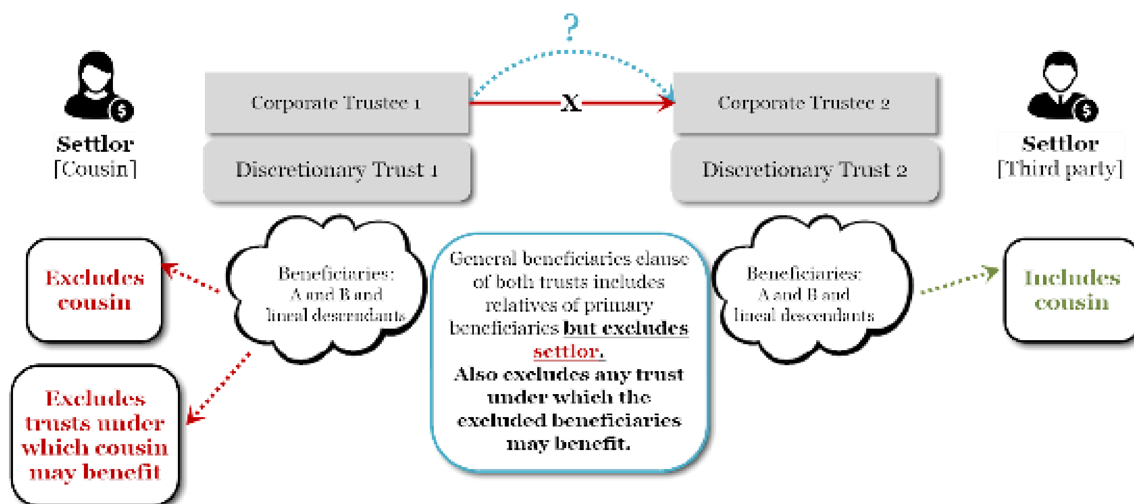
How the "wait and see" rule will operate in practice is not known. It is questionable whether anyone will assess the rule against perpetuities and the operation of the "wait and see" rule when the transferor and transferee trusts ultimately vest, particularly in relation to distributions of income. The safest course of action is to ensure that all trusts of a family group use the same fixed perpetuity period as the oldest trust in the group. This can be overly restrictive, particularly where a later established trust may never receive a distribution from an earlier established trust.

One way of bringing the issue to attention of the next generation is to include a statement of wishes in the primary individual's will, directing the trustees to ensure that any later established trusts that receive a distribution from earlier established trusts, vest within the perpetuity period of the earlier established trust.

Care must also be taken in relation to the application of the "wait and see" rule to trusts established prior to the introduction of the relevant state legislation. In Victoria, the legislation applies only to trusts established after the date of its commencement (1968). Distributions made by trusts established before the commencement of the relevant legislation will be reliant on the common law rules, where there is "no wait and see" rule. Therefore, such distributions may be void from the outset.

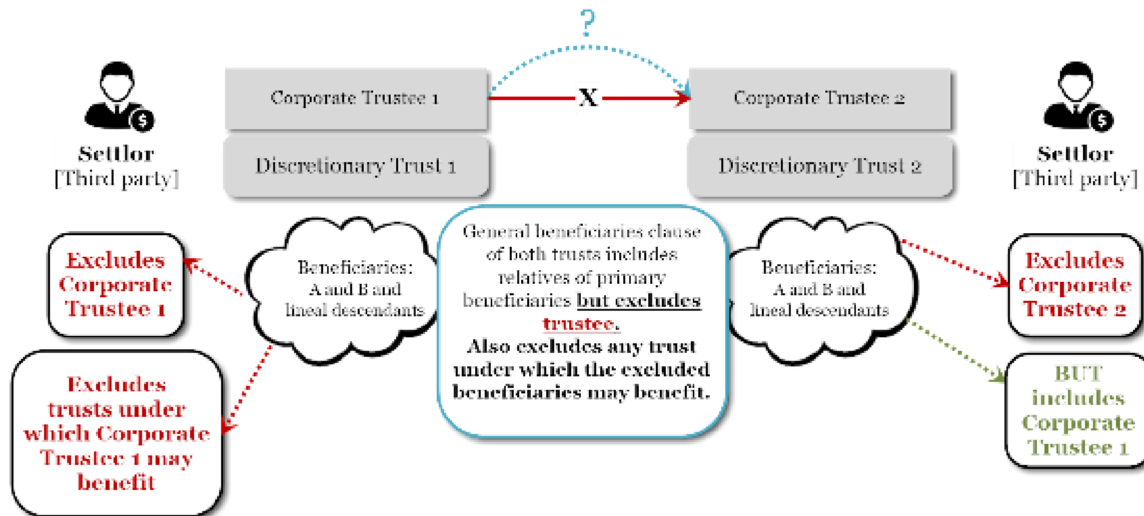
## Deed provisions

The distributing trust will be likely to exclude the settlor as a beneficiary and possibly any trust of which that settlor is a beneficiary. If this is so, where the receiving trust has been established by another settlor and includes the settlor of the original trust as a beneficiary, the receiving trust would be excluded from being a beneficiary of the distributing trust.




Similarly, assume a distributing trust excludes its trustee as a beneficiary and any trust of which that trustee is a beneficiary. In that case, a receiving trust that provides for a wide range of beneficiaries, including companies in which related beneficiaries may hold shares, may be excluded as a beneficiary of the distributing trust.

[14] *Nemesis Australia Pty Ltd v Commissioner of Taxation* [2005] FCA 1273.




## Can you "reverse" the exclusion?

It may be possible to "reverse" the exclusion through either variation of the terms of the distributing trust, or in the case where the proposed beneficiary is a trust addressing issues with the terms, class of beneficiaries or the vesting period of the receiving trust.

In considering the possible variation of the terms of the distributing trust, the trustee must carefully analyse:

- whether such variation would be within the power of variation in the deed or beyond power (and, therefore, invalid); and
- whether such variation would trigger a resettlement/creation of a new trust with the resulting loss of beneficial tax characteristics and the potential to incur tax liabilities.

If the proposed beneficiary is a second trust, the trustee should consider using powers in the trust deed of the receiving trust to exclude "offending" beneficiaries that through their inclusion within the class of beneficiaries of the receiving trust are resulting in that receiving trust being deemed to be excluded from the class of beneficiaries of the distributing trust. The trustee of the receiving trust could look to exclude any of:

- the trustee of the distributing trust;
- a notional settlor of the distributing trust; or
- the settlor of the distributing trust,

as beneficiaries of the receiving trust if any of those persons are creating the "trace-through" exclusion problem.

The trustee of the receiving trust could also consider bringing forward the vesting date of the receiving trust to address any problems with the vesting date exclusions where the receiving trust has a later vesting date than the distributing trust.

## Addition of beneficiaries

Although modern discretionary trust deeds are often drafted in such a manner that related entities of the key family members are automatically included within the class of beneficiaries, occasionally the trustee needs to exercise a power in the deed to appoint such related entities as beneficiaries of the trust. In that circumstance, it is critical to strictly follow the terms of the trust deed to ensure that the appointment is effective.

Often appointments of income are made to persons as beneficiaries without any reference to the trust deed, or alternatively, there is simply a resolution of directors of a corporate trustee purporting to nominate a person as beneficiary. A resolution of a director is may not be sufficient to appoint an additional beneficiary.

In addressing whether an entity had been effectively nominated as a beneficiary of a trust, Spender J in *Idlecroft* commented and found as follows:

> 47. Secondly, cl.6 of the trust deed gives power to the Principal to appoint a beneficiary, and cl.6 does not confer power on the trustee to make such an appointment. The Commissioner nonetheless contends that there was a mere irregularity in relation to the nomination of WCC in its capacity as Trustee of the unit trust as a beneficiary of the trust. It was submitted for the Commissioner that where there is power to appoint a beneficiary, a mere irregularity in the qualification of the person as a beneficiary is not, in tax matters, a concern of the Court or the Commissioner.
>
> 48. …. .
>
> 49. The fact that Mr McGowan signed the document "Nomination of General Beneficiary" over the stamp of Downville and as a director of Downville does not, in my judgment, constitute an appointment by him as Principal nor does the document constitute a notice in writing by the Principal to the Trustee appointing WCC to be a beneficiary for the purposes of the McGowan Trust Deed. I reject the contention of the Commissioner that WCC was nominated as a beneficiary of the McGowan Family Trust.[15]

Spender J continued in relation to his finding that the nomination of WCC as a beneficiary had been ineffective:

> 72. I proceed now on the basis that in each appeal the position is that the nomination of WCC as a beneficiary was ineffective, and that the appointment of income to it was therefore a nullity and liable to be set aside ab initio by the Court. Re: Cavill Hotels Pty Ltd [1998] 1QDR 396 at 402; Turner v Turner [1984] Ch 100 at 111; and BRK at par 15.[16]

This demonstrates that failure to comply with the terms of a trust deed when nominating beneficiaries may have dire, or at the very least, unintended consequences.

Prior to nominating a person to be a beneficiary of a trust the questions to be answered are:

- Is there any power included in the deed to nominate any persons as additional beneficiaries of the trust?
- If the answer to the first question is no, can the trust deed be varied to include the necessary power to nominate beneficiaries?
- If the answer is yes, who has the power to nominate beneficiaries?
- How is the power to nominate beneficiaries to be exercised? For example, by deed of variation or by a resolution passed by the trustee.
- Does the person whom it is proposed to nominate as a beneficiary qualify to be so nominated?
- Is the person to be nominated an excluded beneficiary?

Only after these questions have been answered should the nomination of additional beneficiary proceed.

[15] *Idlecroft* paras 47 and 49.
[16] *Idlecroft* para 72.

# Taxation Implications

If the objective of a trustee of a trust is, at the trustee's discretion, to create enforceable entitlements to the income and capital of the trust, then for any taxation liability attaching to the entitlements created to follow those entitlements, it will be essential for the trustee to be satisfied that the persons in whose favour an entitlement is to be created are beneficiaries. The beneficiaries will include persons nominated by the trustee or some other person, for example the guardian, under and in accordance with an express power in the trust deed and who are not specifically excluded as beneficiaries.

If a person in whose favour the purported creation of an entitlement in the income of a trust has been exercised is not a beneficiary of the trust in whose favour income can be appointed, and this issue was placed before a court for consideration, a determination would necessarily be made as to where liability would fall for the tax payable in respect of the ineffective appointment.

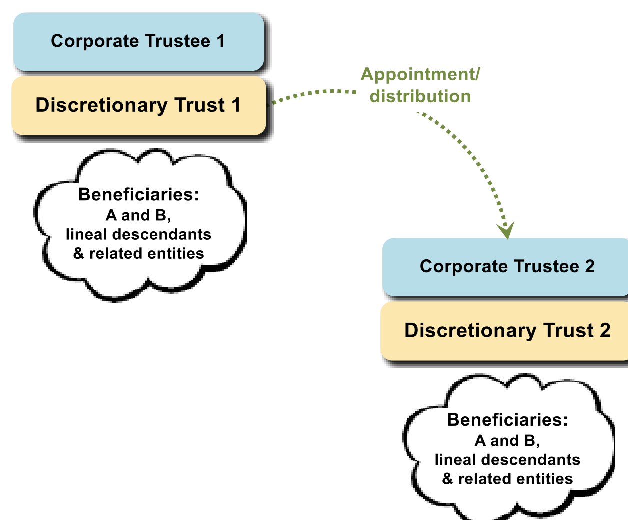
If the trust deed of a trust provides that income not the subject of an effective determination or appointment by the trustee will be income to which specific or default beneficiaries will be entitled, then those beneficiaries will be entitled to that income and it will be included in their assessable income in the proportions to which they are so entitled.[17]

To the extent that a present entitlement in any part of the income of a trust has not been created in favour of beneficiaries, the trustee will be assessed to tax on that part of the income.[18] The ATO will assess the trustee to tax under the provisions of section 99A of ITAA 36.

If it is intended that any part of the income of a trust in an income year which has not been the subject of an effective determination is to be taken to be the income of specific beneficiaries the trust deed must be clear in its terms to that effect.

# Can you make the distribution?

In managing the trust, consideration often turns to the making of appointments of income or capital of the trust to beneficiaries of the trust. For this part of the paper, we will consider these distributions in light of a scenario whereby Discretionary Trust 1 (**distributing trust**) makes an appointment (**distribution**) in favour of Discretionary Trust 2 (**receiving trust**).




There are a number of preliminary issues that should be addressed before making a distribution including:

- Is it a distribution of income or capital?
  - Is there an income appointment power/capital appointment power in the trust deed?
  - Are there sufficient reclassification powers in the trust deed?

[17] Section 97 of ITAA 36.
[18] Sections 99 and 99A of ITAA 36.

  - Are there selective streaming/categorisation powers in the trust deed?
- Is the ability to make the distribution a restricted power/reserved power or subject to some other form of restriction?
- Does the exercise of the power require the (prior?) consent (in writing?) of a named party (Appointor/Guardian/Principal)?

Each of these matters needs careful consideration to ensure the proposed action is undertaken in compliance with the trust deed so as to not be treated as void.

## Consider Family Trust Election implications

The key issue concerning family trust elections (FTEs) in the context of practical management of trust distributions is the potential for Family Trust Distribution Tax.

Advisers need to ensure that there is no liability to Family Trust Distributions Tax arising where one of the trusts has made a FTE or an Interposed Entity Election (IEE) and, yet, the other trust either has not made any such election or has made such an election, but has nominated a different test individual.

# Advantages of a discretionary trust

## Asset protection

The first advantage of a discretionary trust owning assets, or conducting a business, is that no one beneficiary has any claim to the assets of the trust. As a result, the trust is the best means of owning assets for the purposes of asset protection. For example, assume a trust owns a business as well as the premises from which that business is conducted. Further suppose that as a result of a speculative investment by a beneficiary, perhaps in property or in shares, the beneficiary encounters financial difficulty. Because the beneficiary does not have any claim to or ownership of the assets of the trust (unless there is money unpaid and owing to him/her by the trust), the creditor of the beneficiary cannot attempt to seize the assets of the trust to satisfy the debt. This would be different if the beneficiary was a shareholder in a company that owned assets in its own right. In this situation, the shares would be available to the beneficiary's creditors.

By way of further example, if the beneficiary is involved in Family Court property proceedings, the Family Court cannot direct that the assets of a properly structured trust be used to satisfy the claim of a spouse in the proceedings.

## Flexibility in distribution of income

The second advantage of a discretionary trust is that it allows trust income or capital to be distributed between beneficiaries in the most tax effective manner. The trustee is required to distribute the income in each year between the beneficiaries or to accumulate it (although accumulation may result in more tax being paid on that income). The trustee can elect to distribute income to any one of the primary or general beneficiaries, none of whom have any enforceable right to require that any portion of income or fixed sum be paid to them in any year. The trustee has similar power to distribute capital during the life of the trust.

## Capital gains tax concessions

The third advantage of holding an investment through a trust is that certain taxation advantages arising from the imposition of CGT apply in respect of discretionary trusts. These advantages are unavailable (or available to a lesser extent) to unitholders in a unit trust and shareholders in a company.

## Estate planning

Trust property is not owned by any beneficiary and therefore cannot be passed by a beneficiary's will. Control of the trust, and thereby the trust assets, can be passed to the next generation by appropriate consideration of the appointor provisions. For example, the trust deed can provide that, following the death of the original appointors of the trust, their children become the appointors. In that way, the children obtain control of the trust following their parents' death, in much the same way as they would if the assets were passed by will directly on their parents' death.

The benefit of the assets being held in a trust is that, if following the death of the original beneficiaries their children are involved in a matrimonial dispute, or encounter financial difficulties leading to bankruptcy, the assets retained in a properly structured trust would not be exposed in the first instance to distribution by the Family Court; in the second instance, the assets would not be exposed to sale and distribution among creditors, as neither the Family Court nor creditors would have title to the trust assets through the exposed children. If funds are required by the children for any specific purpose, the asset can either be acquired by the trust, or a loan can

be made by the trust to them (the loan being secured by a mortgage over any asset purchased). A distribution of part of the capital can also be made from the trust.

# Advantage 1: asset protection

## Family Court proceedings protection

Suppose that Harry's marriage fails. For the purposes of Family Court property proceedings, Harry must itemise his assets so that the court can make a division of them between himself and Meghan. Harry must list things that he owns or has a legal right to. This includes his car, his computer, his superannuation scheme and so on. Harry's rights in the trust are discretionary, as the name of the trust indicates. Harry has no enforceable right to any of the assets or income of the trust. He must list the trust's assets and the Family Court may take them into account for the purpose of apportioning the marriage assets, but the trust's assets cannot be taken from the trust in the proceedings.

## Protection of assets in a discretionary trust compared with protection in other structures

This situation should be contrasted with the outcome of other financial arrangements. For example, suppose that Harry was not a beneficiary of a discretionary trust, but directly held shares in an investment company that owned the assets and generated the income described. Harry would own the shares in the investment company beneficially (ie for his own benefit) and they would form part of Harry's property available for distribution under a Family Court order. The following table sets out what would and what would not be protected from a Family Court order.

| Arrangement | Protected status |
|---|---|
| **Harry is a beneficiary in a discretionary trust** | Harry's interest is protected as described above. Strictly speaking, Harry doesn't have an interest in the income or capital of the trust at all.<br><br>However, it is important to note that the factual circumstances may be such that the Family Court could deem Harry to have an interest in the trust. If Harry was both a beneficiary and had operational control over the trust through the position of trustee, guardian and appointor, the Family Court may consider that those rights and powers under the trust held by Harry are property for the purposes of s 79 of the Family Law Act 1975 that has a value equivalent to the value of the assets held by the trust (refer *Kennon v Spry; Spry v Kennon* [2008] HCA 56). |
| **Harry is a unitholder in a unit trust** | Harry's interest is not protected. The assets held by the trustee in the trust would not form part of any division calculations in a family law property settlement, but the units owned by Harry would. This is because the units give Harry a right to a certain portion of the income and capital of the trust |

| | |
|---|---|
| | (according to the number of units he holds and the terms of the trust deed). |
| **Harry is a shareholder in a company** | Harry's interest is not protected. The assets held by the company would not form part of the division calculations in a family law property settlement, but the shares owned by Harry would. |
| **Harry is a beneficiary in a discretionary trust and the trust has made a distribution of income to him** | Harry's interest in the trust itself is protected as described above. Harry, however, owns outright any income or capital distributed to him (including those amounts not yet paid). The entitlements can be taken into account by the Family Court and are not protected. |
| **Harry is a beneficiary in a discretionary trust and the trust owes him money** | This is similar to the example given immediately above. Harry has no interest in the assets or income of the trust generally but does to the extent that the trust owes him money (say he lent the trust money or it hasn't yet paid him the amount of a distribution). That money is Harry's property and is not protected. |

### Bankruptcy proceedings protection

Another example illustrates the protection offered where a trustee of a discretionary trust conducts a business. Suppose that the website design business continues to do well but that Laura has, in her own name, borrowed heavily to invest in poorly performing listed shares and she becomes bankrupt when the bank attempts to recoup its loan to her.

Only assets belonging to Laura can be used to pay her creditors. Laura does not own the website design business. Busco Pty Ltd owns it. None of the assets which Busco Pty Ltd owns as trustee of the A Business Trust could be used to satisfy the creditors' claims unless:

- Busco Pty Ltd, as trustee of the A Business Trust, had guaranteed the bank's loan to Laura; or
- the claw-back provisions of the Bankruptcy Act 1966 could be applied to the original transfer of the website design business to Busco Pty Ltd.

Laura could continue to work in the business without the business being affected by Laura's bankruptcy.

The above table would apply to Laura and to the bankruptcy proceedings in the same way as it applies to Harry and the Family Court proceedings, except that the reference to the Family Court treating the rights and powers under the trust held by Harry as property should be compared to the decision of the Federal Court in *Richstar*.

## Advantage 2: flexibility in distribution of income

The A Family Trust has income for the year of $150,000, derived solely from the website design business.

At the end of the fifth year of trading, the A Investment Trust has assets of $850,000. Included in this figure is an amount of $100,000, which represents net income that the A Investment Trust has received throughout that year. The accounts of the A Investment Trust show this income to be made up of:

- $65,000 rent from the investment property; and
- $35,000 rent from the holiday home.

Investco Pty Ltd decides to distribute the income of the fifth year to the primary beneficiaries. It does not distribute to the primary beneficiaries equally; that is, Laura receives much more income than any other beneficiary. This reflects the fact that rights to the income of the trust (and similarly, to its capital) are discretionary and can be distributed at the sole discretion of Investco Pty Ltd.

## Income tax calculations

If Investco Pty Ltd distributes the whole of the net income of the A Investment Trust of $100,000 to Simon, that amount will be included in Simon's assessable income. In these circumstances, the trust pays no tax on that income. However, if the trust did not distribute that income in its year of receipt (and was therefore deemed to have accumulated the income) the trustee would have to pay income tax on that amount at the top marginal rate. Simon, by comparison, as an individual, pays tax on his income at the applicable marginal rates.

# Advantage 3: CGT concessions

A discretionary trust may access all of the CGT concessions on the disposal of the CGT assets. In this respect, a discretionary trust has similar tax treatment to an individual. It is the flow-through nature of the taxation of discretionary trusts that results in this similar treatment.

However, as it is the flow-through nature of the discretionary trust that allows it to access the CGT concessions, the manner in which the amount of the capital gain is distributed must always be considered. For example, should the capital gain be distributed by the discretionary trust to a company, the benefit of the 50% CGT discount would no longer be available.

The benefit is no longer available because, although the 50% CGT discount may be applied at the discretionary trust level, Subdiv 115-C ITAA97 requires that when the amount of the capital gain is distributed to a beneficiary, that beneficiary must then gross-up the amount of the net capital gain to include the amount of the 50% CGT discount. The 50% CGT discount is then subsequently reapplied (after offsetting any capital losses held by the beneficiary). Accordingly, where the amount of the capital gain is distributed to a company, the company will not be able to reapply the 50% CGT discount after the amount of the capital gain is grossed up. Effectively, this achieves a similar result as if the discretionary trust is unable to access the 50% CGT discount in the first instance. Therefore, the amount of the net capital gain will need to be ultimately distributed to natural persons within the same financial year as that in which the CGT event generating the capital gain occurred. If such a distribution is not made, the 50% CGT discount will not be available.

The care that needs to be taken to ensure that the benefit of the 50% CGT discount is obtained previously applied when considering the small business retirement exemption. Although an individual could access the exemption through having the amount of the capital gain deemed to be an eligible termination payment (ETP), a discretionary trust needed to ensure it not only had a controlling individual, but actually paid an ETP. Paying the ETP required the termination of the employment of the CGT concession stakeholder who received the benefit of the small business retirement exemption.

From 1 July 2006, it was no longer necessary for a discretionary trust to actually pay an ETP in order to access the small business retirement exemption; instead the CGT exempt amount was treated as if it was an ETP. The provisions were further amended by the Superannuation Legislation Amendment (Simplification) Act 2007 with effect from 1 July 2007. The amended provisions removed the reference to ETP and instead operate to treat the payment as being made in consequence of the termination of employment of the CGT concession stakeholder. Further, the range of individuals that may satisfy the definition of CGT concession stakeholder has been expanded. It is no longer necessary to be a controlling individual or a spouse of a controlling individual who receives a distribution from the trust. It is now sufficient to be a significant individual or a spouse of a significant individual who receives a distribution from the trust.

In general terms, in a discretionary trust a significant individual for an income year is one who, when considering both direct and indirect distributions, receives distributions of at least 20% of the income and capital of the trust made in that year, if the trustee of the trust makes such distributions in that year.

# Other asset protection features of a discretionary trust

## Advantages of an independent appointor

Often the primary beneficiaries wholly constitute the appointors. However, providing for an independent appointor can have many advantages. The first advantage is that an independent appointor can act as a mediator between appointors if a dispute arises. This, of course, is particularly important when the appointors are not the primary beneficiaries but rather become so as successors to the original appointors.

Some trust deeds provide that, on an appointor being declared bankrupt, the appointor is automatically disqualified from continuing to act as an appointor. The reason for this is the concern that a trustee in bankruptcy may attempt to exercise the power of appointment as an asset of the bankrupt that the trustee in bankruptcy may control. The trustee in bankruptcy may exercise the power of appointment to appoint himself, or his nominee, as trustee of the trust and that new trustee may then realise the assets of the trust and distribute the proceeds to the bankrupt appointor. As those proceeds would be assets coming into the hands of the bankrupt appointor during the period of the bankruptcy, they would be available for distribution by the trustee to the bankrupt's creditors.

To date, this power of appointment has been held by the courts not to be an asset of the bankrupt that is capable of vesting in a trustee in bankruptcy. However, there have been pronouncements by the courts and by the legislature that indicate that, at some time in the future, this particular aspect of the law may change and the power of appointment may fall within the control of the trustee of a bankrupt appointor.

If the deed provides that a person is not entitled to continue to act as an appointor on his bankruptcy, the possibility of the power of appointment being an asset capable of being seized by the trustee in bankruptcy does not arise. However, this scenario illustrates the second advantage of having an independent appointor. For example, if the bankrupts were trustees as well as appointors, the independent appointor, being someone in whom the parties establishing the trust had absolute faith and confidence, could act to replace the bankrupts with a new trustee who was not otherwise linked to them. This would protect the trust assets from seizure in the bankruptcy.

If the trustee is a company in which the bankrupt appointors hold the shares, the trustee in bankruptcy could take those shares and, using the voting rights attaching to the shares, appoint himself and his nominee as directors. These directors could then exercise their powers to realise the trust assets and distribute the proceeds to the bankrupt appointors. The proceeds would then be available for distribution among the bankrupt's creditors. If there was an independent appointor this could not occur because the independent appointor, being the sole remaining appointor (the bankrupts having been excluded), would replace the corporate trustee with an appropriate new trustee.

A third advantage of having an independent appointor arises if the appointors are involved in a Family Court property dispute. This is often relevant where, for example, children of the original appointors become appointors subsequent to their parents' death. This issue is also relevant if there is only one appointor. If two parties are appointors and involved in Family Court proceedings, the Family Court may be able to direct that the appointors act in a certain way, for example, to appoint one of them as trustee. This trustee would then be able to realise the assets of the trust and distribute the proceeds to the parties or in accordance with the Family Court's orders.

A person who is not a party to the marriage cannot currently be subject to Family Court directions unless they hold assets of the marriage. Therefore, if there is an independent appointor, the appointors cannot be directed by the Family Court to exercise the power of appointment in a manner directed by the court. If the deed does not

provide that the appointors must act jointly (ie the majority vote prevails) and the appointors are a husband, wife and independent appointor then the court may be able to control the decisions of the appointor by a two to one majority.

The following table summarises these issues.

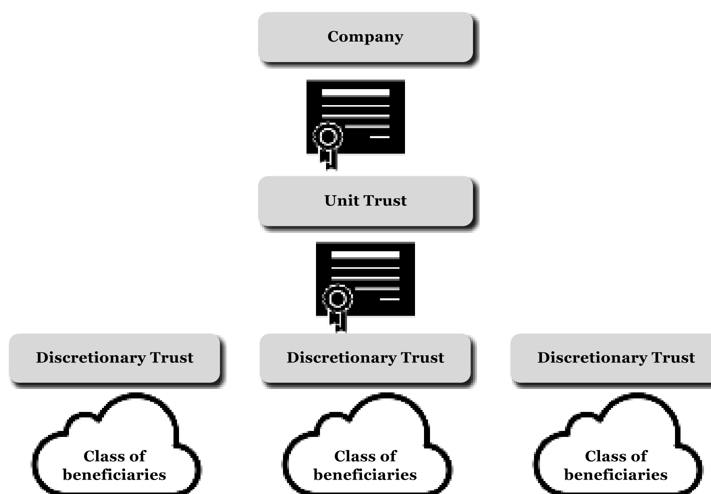
| | Discretionary Trust – Key Factors |
|---|---|
| **Asset protection** | The structure is protected from claims by creditors of beneficiaries. |
| | Beneficiaries are protected from claims by creditors of the structure. |
| | Assets are protected from claims by future spouses of principals and children. |
| | Note: the indication of the availability of asset protection is based on the structure itself. Care should always be taken to review loans, entitlements and any personal guarantees that may exist between the various parties. |
| **Income taxation** | Income accumulated by the structure will be taxed at the highest marginal income tax rate plus the Medicare levy. |
| | Flow-through taxation applies, so that income distributed by the structure will be taxed in the hands of the recipient at their income tax rate. |
| | There is flexibility to distribute income (including income with special characteristics, eg franked dividends) to any one or more beneficiaries (subject to personal services income and Pt IVA issues). |
| **Capital gains tax concessions** | 50% CGT Discount – available to structure.<br>Small business CGT concessions – available to structure.<br>CGT concessions only relates to the availability to the structure. Consideration must be given to the requirements for accessing the concessions outlined in the ITAA97 and the requirement to distribute amounts of net capital gains in some circumstances to avoid the benefit of the concession being eroded by the gross-up rules in Subdiv 115-C ITAA97. |
| **Succession planning** | The assets of the structure are not owned by any one beneficiary and do not form part of a beneficiary's estate on their death. |
| | Ultimate control of the trust resides with the appointor. |
| | Ultimate control of the structure may be planned by appropriate drafting of the appointor provision. |
| **New investors** | Beneficiaries may be added to the structure. Adding beneficiaries may cause a resettlement that incurs CGT and stamp duty liabilities. |
| | The structure is not capitalised by beneficiaries. |
| **Other issues** | The trustee on behalf of the trust may need to make a family trust election if:<br>• a beneficiary is to receive the benefit of franking credits attaching to dividends paid in respect of shares acquired after 31 December 1997; and<br>• the beneficiary will have greater than $5,000 in franking credits (in total and from all sources) in the applicable financial year. |

# Structures for multiple parties / family groups

## Building blocks of structures

For all the advantages of the discretionary trust it is important to note that it may only be one "building block" in a larger structure.

Where multiple parties / family groups are to be involved in the investment or particular interest deductible financing arrangements are required the parties may want to adopt a structure that allows for multiple party participation such as a **company**, **unit trust** or **partnership/joint venture** – or combinations of these.




The advantages and disadvantages of these multi-party investment structures are compared in the table below. However, the important issue to note is that many of the advantages of discretionary trusts may be preserved where it is the interest holder in the multi-party structure.

## Partnerships vs joint ventures

There is often misunderstanding as to the distinction between partnerships and joint ventures. Often arrangements that are described as joint ventures are partnerships at law and therefore agreements regarding sharing of liabilities may be ineffective given partners are jointly and severally liable for the debts of the partnership. The agreement between the parties becomes more an indemnity arrangement between the partners but doesn't prevent creditors seeking recovery against only one of the partners direct.

### Partnership

- Where parties are in receipt of income jointly.
- Partnership terms may be expressly agreed in writing or by State based partnership law.
- Partnership assets are owned by the partners.
- Partners are jointly and severally responsible for the liabilities or debts of partnership.

### Joint venture

- Parties make contributions different in type, amount or timing.
- Venture usually has a defined end and is formed for a particular project or outcome.

- Parties are only responsible for the liabilities or debts of the venture in the proportion determined in the joint venture agreement.

## Companies with discretionary trust shareholders

A private company will permit the retention of income at the corporate tax rate and reinvestment into the business. A company provides a high degree of insolvency protection and has a well-defined corporate governance process.

However, disclosure requirements and rules protecting minority shareholders under CA 2001 may make use of a private company unattractive.

A company has extensive tax treatment that must be managed including:

- a company cannot distribute tax losses to shareholders;
- a company is subject to restrictions on the deductibility of losses and bad debts;[19]
- a company has restrictions on dividend policies;[20]
- restrictions on share buy-back and share issue transactions;[21]
- ineligibility for the CGT 50% discount;[22]
- restrictions on access to the CGT small business concessions;[23]
- regulation of share value shifting activities;[24] and
- regulation of debt/equity interests.[25]

The loss of the CGT 50% discount and the restrictions on flexible dividend streaming[26] are significant disincentives for using a company.

The dividend streaming flexibility can largely be addressed by having a discretionary trust own the shares in the private company.

A single tier private company structure means that any retained earnings are exposed to the creditors of the private trading company. Accordingly, it may be appropriate to include a holding private company to which retained earning can be paid to and held separate from the private trading company.[27]

[19] Division 36 ITAA 36 (prior year losses); Division 165 ITAA 97 (current year losses and bad debt deductions); Division 175 (current year deductions); Division 170 ITAA 97 (inter company loss transfers).

[20] Division 7A ITAA 36 (deemed dividends); Section 109 ITAA 36 (excessive remuneration); Divisions 202-207 ITAA 97 (imputation credits); section 160APHC-160APHU ITAA 36 Former Division 1A (45-day holding period rules); Division 197 ITAA 97 (share tainting rules).

[21] Division 16K ITAA 36; PSLA 2007/9 (buy-backs);TR 2008/5 (share allotments); Chapter 2J CA 2001.

[22] Section 115-10 ITAA 97.

[23] Section 152-10(2) ITAA 97.

[24] Division 138-140 ITAA 97.

[25] Division 725 and 727 ITAA 97.

[26] See P Sokolowski, 'Unlocking value from private companies', TIA South Australian Convention, 7 May 2009.

[27] However it is important to note that s,588V and s.588W of the Corporations Act 2001 (Cth) may allow the trading subsidiary company's liquidator to recover from the holding company, as a debt due to the trading subsidiary company, an amount equal to the amount of the loss or damage suffered by a person as a result of the trading subsidiary company incurring debts whilst insolvent.

# Comparing options

## Advantages and disadvantages

| Company | | Discretionary Trust | | Unit Trust | | Partnership/Joint venture | |
|---|---|---|---|---|---|---|---|
| Advantages | Disadvantages | Advantages | Disadvantages | Advantages | Disadvantages | Advantages | Disadvantages |
| • Limited liability asset protection for shareholders.<br>• Access to some advantages of DT with DT shareholder.<br>• Can retain profits. | • Division 7A tax risks in relation to non-commercial transactions with related parties.<br>• No 50% CGT discount at company level.<br>• Limited flexibility of distribution as compared to other structures (share rights).<br>• No flow-through taxation.<br>• Regulatory compliance obligations. | • Asset protection to structure.<br>• Asset protection to beneficiaries.<br>• Flexibility of distribution.<br>• Ability to access losses.<br>• Succession planning without triggering tax event.<br>• Extraction of capital without triggering tax liability. | • Critical to read the deed to understand how structure operates.<br>• Traps with beneficiaries.<br>• Traps with multiple family groups.<br>• Need to exclude foreign beneficiaries for residential land investments. | • Access to advantages of DT with DT unit holder.<br>• Ability to add new investors without triggering a CGT liability.<br>• Flow-through taxation for income. | • CGT event E4 trap<br>• Franking credit flow-through trap.<br>• Challenges in accessing losses.<br>• Danger of reliance on unit trust deed to manage third party investor disputes. | • Access to advantages of DT with DT partner.<br>• Each partner may make their own Family Trust Election for purpose of access to losses ad income injection<br>• Availability to small business CGT concessions incl passive land used in business of connected entity | • Joint and several liability<br>• CGT liability triggered on partnership changes<br>• Challenges on partnership vs joint venture distinction.<br>• Complex administration and management of structure. |

# Key taxation challenges

The table below summarises some of the key taxation challenges faced by structures and illustrates whether those issues impact on the relevant structure.

| | Company | Discretionary Trust | Unit Trust | Partnership |
|---|---|---|---|---|
| Taxation at entity level | ✓ | - | ✘ | ✘ |
| Flow-through taxation | - | ✓ | ✓ | ✓ |
| Extraction of capital from structure | ✘ | ✓ | ✓ | ✓ |
| Division 7A implications | ✘ (applies) | - | - | - |
| Family Trust Elections | N/A | ✓ | ✘ | ✓ |
| 50% capital gains tax concession | ✘ | ✓ | ✓ | ✓ |
| Accessing franking credits | ✓ | ✓ (Make FTE) | ✘ (PBR req'd) | ✓ (Make FTE) |

# A brief recap on Division 7A and an overview of Unpaid Present Entitlements

Division 7A of ITAA 36 is a complex area for practitioners and asset owners. To help manage this, it is important for to ensure their structure is right from the onset and to be mindful of the implications that different vehicles will have for Division 7A purposes.

It is beyond the scope of this paper to include a comprehensive analysis of Division 7A of the ITAA 36 and address the many issues involved with Division 7A and its implications for structures. This paper will address the importance of being mindful of Division 7A when choosing a structure. A brief overview of the relevant Division 7A provisions are included below to assist with this.

Division 7A operates to prevent profits or assets being extracted from companies and provided to shareholders or their associates (through payments, loans or forgiven debts) where income may have benefited from the lower corporate tax rate rather than the potentially higher individual marginal income tax rate. Division 7A is a concern for complex family groups, as the liability triggered pursuant to the provisions is an unfranked deemed dividend - a significant penalty for tax purposes.

Standard loans from a company to the shareholder in the company or an associate of that shareholder do not trigger liabilities pursuant to Division 7A of ITAA 36 where they are subject to loan agreements complying with the provisions of section 109N of ITAA 36. The compliant loan agreement, in simple terms, is either a seven-year loan with principal repayments each year and interest at a statutory rate, or a 25-year loan (secured by a registered mortgage over real property to the value of 110% of the loan) with principal repayments due each year and interest at a statutory rate. The agreement must be in writing.

Subdivision EA of Division 7A of ITAA 36 extends the potential operation of Division 7A to arrangements where a trust makes a payment or loan to a beneficiary who is the shareholder or associate of the shareholder in a company and that company has a UPE in the trust.

Those trust arrangements were further extended by various provisions including section 109XI of ITAA 36. Section 109XI deems there to be a relationship between the trust making the payment or loan to the beneficiary (who happens to be the shareholder or an associate of the shareholder in a company) and the relevant company even though there may not be a direct UPE relationship between those two entities. If there are interposed entities between the primary trust making the loan or payment and the ultimate corporate beneficiary that has a UPE indirectly traced to the primary trust, the Division 7A implications will be triggered.

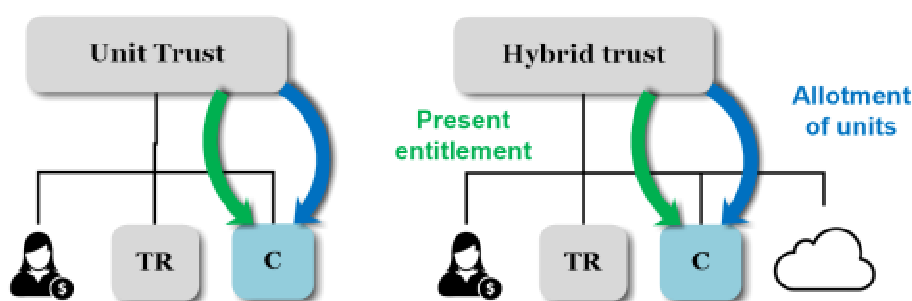
Finally, as a result of Australian Taxation Office (**ATO**) interpretation of the tax law as published in Taxation Ruling TR 2010/3 and Practice Statement Law Administration (**PSLA**) 2010/4, UPEs that have not been called for by their entitled beneficiaries (subsisting UPEs) that are not held for the sole benefit of the beneficiary will be treated as loans for the purposes of Division 7A of ITAA 36.

The ATO interpretation does not apply to UPEs that existed prior to the ATO's first announcement of their change in interpretation on 16 December 2009. Further, it is possible to demonstrate that the subsisting UPE is held for the sole benefit of the company by putting in place an investment agreement arrangement that complies with PS LA 2010/3. Under that practice statement, an option one complying investment arrangement is an interest only arrangement for seven years and an option two complying investment arrangement is an interest only arrangement for 10 years. Different interest rates apply to the option one and option two arrangements. A further option to demonstrate that the UPE was held for the sole benefit of the beneficiary is where the UPE is directly traced to specific assets and all the benefits and income derived from those assets is directly attributed under the sub trust to the beneficiary holding the UPE.

These arrangements are all likely to be reviewed and potentially changed as a result of anticipated amendments to the legislation due to commence 1 July 2020.

# Problematic structures and Div 7A interactions

## Unitised structures




**Present entitlement satisfied by the allotment of units often by trustee's power in the deed to allot units in satisfaction of entitlement.**

## How the unitised structure is proposed to operate

A class hybrid unit trust may permit a private company beneficiary to reinvest a UPE as a subscription of income units so that there is no UPE for the purposes of sections 109D and Subdivision EA. Capital gains can be distributed to a discretionary class beneficiary without CGT event E4 applying.

A class hybrid unit trust is similar to a unit trust where the unit holders are entitled to a proportionate share of both income and capital except to the extent that the trustee exercises a discretion to distribute all or part of the income and capital to a discretionary class or classes of beneficiaries (and as between the members of those classes).

Some advantages of a class hybrid unit trust include:

1. flexible income distributions to the class of beneficiaries and in default, proportionately to the unit holders;
2. the potential to negatively gear the units if the units have a sufficient right to income or to income and capital;[28]
3. taxable and non-assessable capital gains distributions to the class of beneficiaries so that CGT event E4 does not apply;[29]
4. units can be issued to capitalise the trust;
5. units can be transferred to existing or new participants; and
6. asset protection for trust assets where the unit holders only have a right for return of subscribed capital.

Some disadvantages of a class hybrid unit trust include:

[28] R Jorgensen, 'Deductibility of Interest and Taxpayer Alert TA 2008/3', (2008) 42(11) TIA 656 updated for TD 2009/17 but the analysis is unchanged.

[29] TD 2003/28 and NTLG CGT Sub-committee Minutes dated 11 June 2001 at [8.1]

1. difficulties in satisfying the CGT small business concession participation percentages for the stakeholder tests;[30]
2. difficulties in satisfying the trust loss provisions or family trust election requirements;[31]
3. difficulties in satisfying the 45 day holding period rules for distributing franked dividends;[32] and
4. difficulties in superannuation funds investing and satisfying the non-arms length income provisions.[33]

When a private company beneficiary subscribes for units in a class hybrid unit trust, the private company beneficiary pays an amount to the class hybrid unit trust for the purposes of subsection 109C(1) ITAA 1936.[34] The amount of the deemed dividend is equal to the amount paid but is potentially reduced by the value of the units received under section 109J ITAA 1936.

Accordingly, if the private company pays not more than an arm's length price for the units, there is no deemed dividend under section 109C ITAA 1936.

Assuming that the units are issued for $1.00 per unit, the market value of the unit must at least equal $1.00 per unit. If the unit is worth less than $1.00 per unit then there is a discount which will constitute a section 109C ITAA 1936 deemed dividend.

The rights attaching to the unit will determine its value. The market value of an income unit with a proportionate right to all distributable income and the return of the paid-up capital is unclear. A market valuation may need to be obtained. It is unclear whether an income unit of this type would be considered a wasting asset. Accordingly, it may be necessary of the income units to have a right to return of the paid-up price plus consumer price index. However, this would result in a capital gain to the private company beneficiary which would not be subject to the CGT discount.

There is also the question as to whether the private company "makes" a payment if it undertakes no action in relation to the acquisition of the unit, but instead the terms if the trust deed provide that a distribution may be satisfied by the trustee allotting units at it sole discretion.

## ATO concerns with such structures

The ATO has expressed its concerns with taxpayers adopting such structures. These concerns have been outlined in presentations at industry events[35] and now through ATO website guidance.[36] Currently the website guidance states:

> We've identified cases where a private group seeks to extinguish unpaid present entitlements (UPEs) or avoid obligations under Division 7A by implementing an arrangement where a private company subscribes for units in a unit trust. The unit trust may then provide payments or loans to other entities within the private group.

The ATO are primarily concerned where the unit trust provides payments or loans to other entities within the private group. It is less clear how the ATO view these arrangements where the funds have been retained within the trust in working capital. However, the application of the tax law under the interpretation of the ATO

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[30] Section 152-70 ITAA 1997.

[31] Schedule 2F ITAA 1936.

[32] Section 160APHL ITAA 1936.

[33] Division 295 ITAA 1997 and TR 2006/7.

[34] Refer by analogy to PBR 80565 (section 109C) and PBR 89898 (Subdivision EA) where a subscription for shares in a private company constituted a payment.

[35] For example, Fiona Dillon at The Tax Institute National Convention – 15 March 2017 and Fiona Knight at The Tax Institute Trusts Day, Perth – 13 June 2017

[36] Refer: https://www.ato.gov.au/General/Tax-planning/In-detail/Unit-trust-arrangements/

(particularly the application of 109C) appears to apply independently as to how the trust may have applied the relevant amount.

The ATO identify the following provisions as having potential application:

1. Section 109C of ITAA 36 - payments.

    a. If the payment of units is not at market value, the exclusion in 109J does not apply. The ATO have expressed a view in presentations on the issue that the terms of the trust deed and the rights of the unit holders often contradict the "market value" ascribed to the units by taxpayers.

2. Section 109T of ITAA 36 – interposed transactions.

    a. Refer to Taxation Determination TD 2018/13 (originally released in draft as TD 2017/D3).

3. Section 100A of ITAA 36 - reimbursement agreements.

4. The anti-avoidance provisions of Part IVA ITAA 36.

These issues are quite technical and beyond the scope of this paper. This paper will not further consider the issues but just brings them to the attention of advisers as a warning as to the care required when looking to adopt such arrangements.

# Division 7A - pros and cons of companies

In summary, the pros and cons, for Division 7A purposes, of using a company as the investment vehicle are as follows:

| Pros | Cons |
|---|---|
| Less complex working capital financing:<br>• Avoid complexity of Subdivision EA<br>• Avoid complexity of s.109XI<br>• Avoid complexity of TR 2010/3 and PSLA 2010/4 option 1 and option 2 investment agreements to provide a return to the corporate beneficiary | Capital extraction problematic<br>• s.109C payment<br>• “profits first” rules – franked and unfranked dividends, capital reductions, buy-backs, liquidations and operation of s.45B ITAA 36. |
| Can extract funds from exposed trading subsidiary to a passive corporate head entity without triggering Div 7A management issues | Use of asset potentially triggers s.109CA payment |
| Can finance other corporate entities where funds retained within corporate group with s.109K exemption. | Still need to consider s.109T |
| Potential to retain profits at lower corporate rate (not taxed at 30% as a corporate beneficiary) | Need to be mindful of proposed removal of distributable surplus requirement |

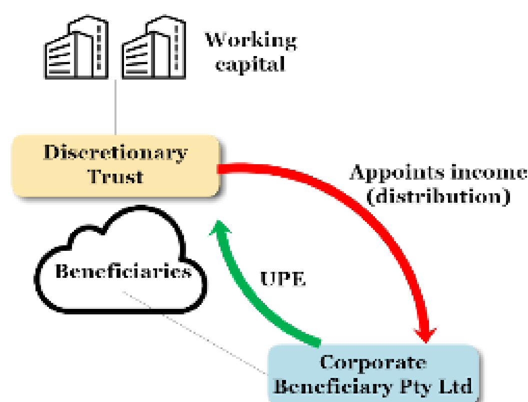
These issues are addressed below.

## Pro: Less complex working capital financing

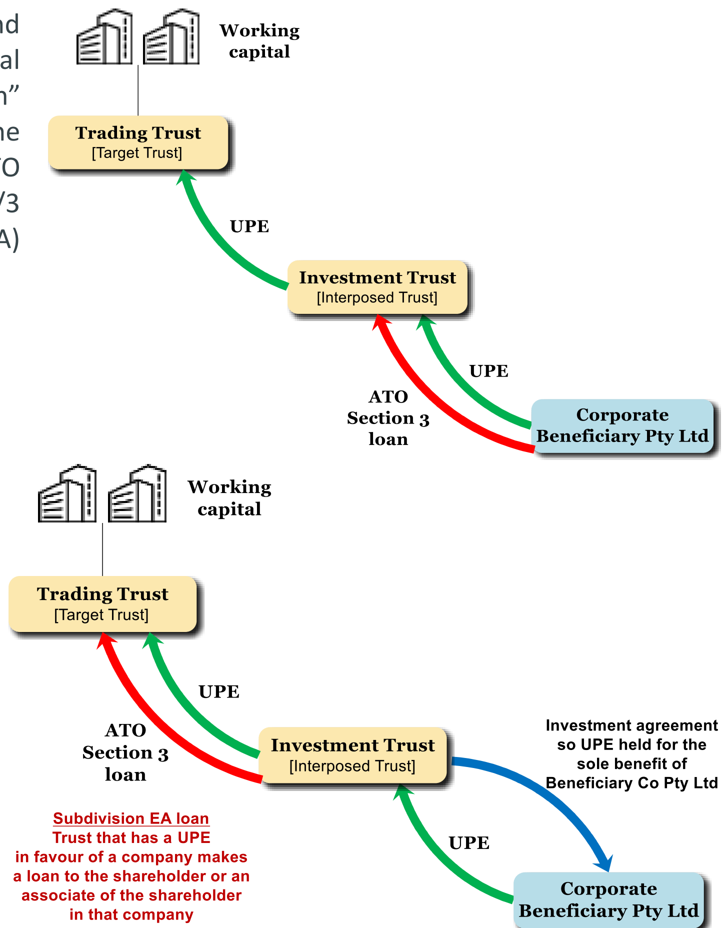
A company is able to retain profits at corporate rate. This can be done without the complicated financing arrangements associated with other structures.

The diagram below illustrates the complexity involved when a discretionary trust is conducting an active trading business and needs to retain taxable profit as working capital. Whilst it could accumulate the income and pay tax at the highest marginal rate plus the medicare levy, it may find it much more tax effective to distribute to a corporate beneficiary and retain the amount after application of the corporate tax rate within the working capital of the trust. This is in essence the fundamental problem of the unpaid present entitlement (UPE) problems with trusts and Division 7A.

The differential is 53% of the after tax profit being reinvested in working capital vs 72.5% or 70% of the after tax profit where a company is used as the trading vehicle.



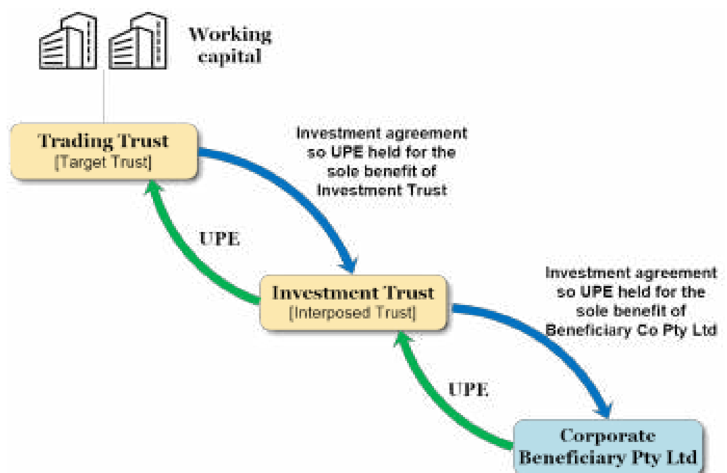
Where the UPE remains unpaid and "subsists" beyond one year, the UPE will be treated as financial accommodation and therefore a "Section 3 loan" provided by the corporate beneficiary to the discretionary trust in accordance with the ATO interpretation outlined in Taxation Ruling TR 2010/3 and Practice Statement Law Administration (PSLA) 2010/4.




Further, even if that direct UPE with the corporate beneficiary was held by the discretionary trust for the sole benefit of the corporate beneficiary as a result of being subject to a complying option 1 or option 2 investment agreement, in multi-trust structures the operation of the combination of the provisions in:

- Subdivision EA of ITAA 36;
- The ATO interpretation in TR 2010/3 and PSLA 2010/4

may see the UPE between the trading (target) trust and an intermediary (interposed) trust treated as triggering the operation of Division 7A. This arises under the standard operation of Subdivision EA as the intermediary (interposed) trust has a UPE in favour of a company and makes a loan (here a deemed Section 3 loan) to the shareholder or an associate of the shareholder in that company (here the trading target trust as the associate).



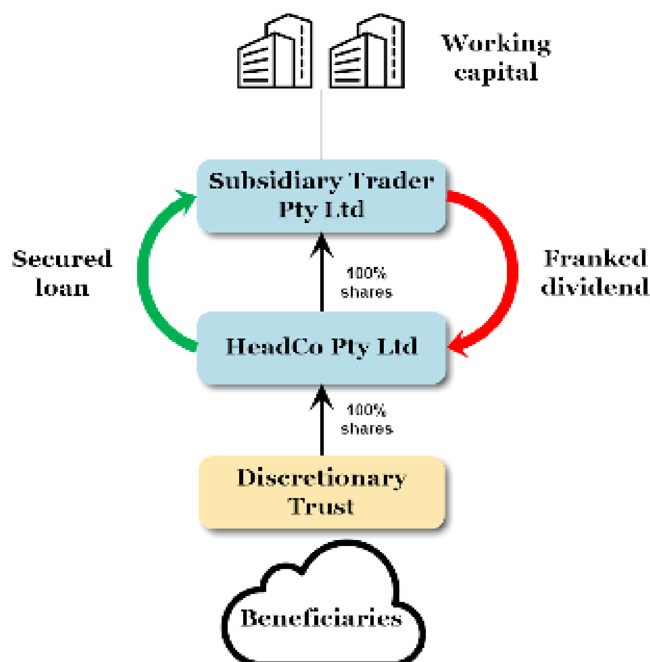

The resolution of the issue necessitates the UPEs through a distribution chain each being held for the sole benefit of the relevant beneficiary. The easiest way to ensure compliance (depending on the nature of the assets held) may be to enter into option 1 or option 2 complying investment agreements through the whole chain. Care must be taken to address tax deductibility of the interest incurred on the investment agreements. Provided the funds are ultimately traced to working capital then this should be able to be satisfied. Where the funds have been extracted for a private purpose then care needs to be taken because of the operation of section 109XI or section 109T of ITAA 36. Either section may apply to trigger a Division 7A liability even though there are investment agreements in place as those investment agreements only deal with the UPE being dealt with as financial accommodation (by ensuring that is not the case). They don't change the fundamental nature of the UPE in existence at trust law. This can then trigger the operation of section 109XI and Subdivision EA of ITAA 36.

## Pro: Can extract funds from exposed trading subsidiary to a passive corporate head entity without triggering Div 7A management issues

Contrary to the problems identified with multiple trust structures noted above, a corporate group may enable a holding company to hold all the shares in a subsidiary trading company.

Then, that subsidiary trading company deals with the public and has the risk exposure.

It can protect retained earnings that are reinvested into working capital by declaring a dividend to the holding company (without a further taxation liability) and then take a loan back of those funds. This enables the retained profits to be held separate from the subsidiary trading company.[37]




## Pro: Can finance other corporate entities where funds retained within corporate group with s.109K exemption

Provided the funds have not been extracted out to a non-corporate entity, funds may be used within a corporate group (even if not consolidated) without a Division 7A liability. Section 109K of the ITAA 36 notes:

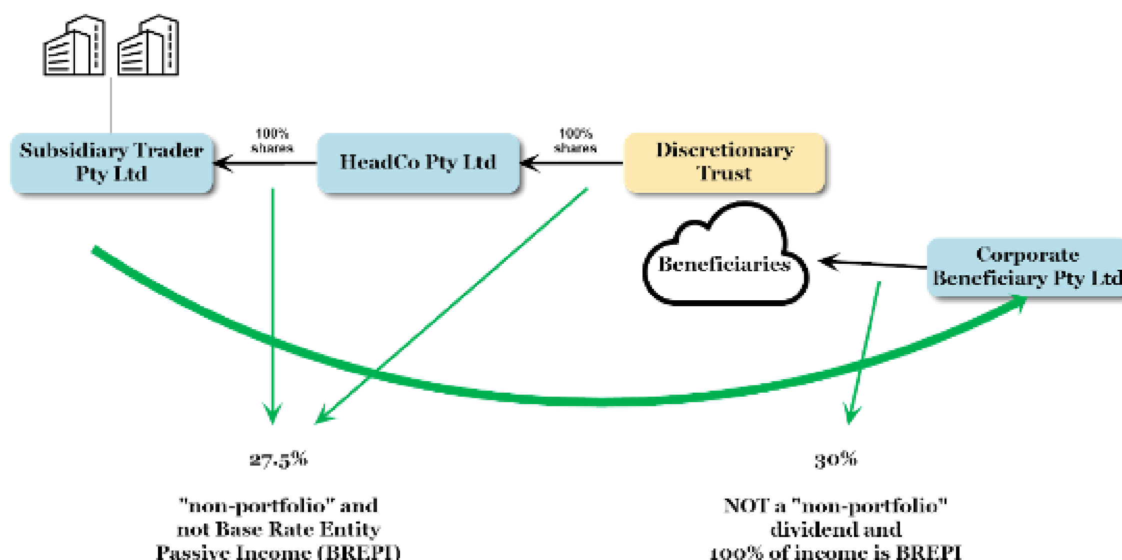
> **S.109K Inter-company payments and loans not treated as dividends**
> A private company is not taken under section 109C or 109D to pay a dividend because of a payment or loan the private company makes to another company.
> Note: This does not apply to a payment or loan to a company in its capacity as trustee. (See section 109ZE.)

## Pro: Potential to retain profits at lower corporate rate (not taxed at 30% as a corporate beneficiary)

Distributions through the corporate chain will remain "non-portfolio" and not Base Rate Entity Passive Income (**BREPI**) and therefore may be taxed at the 27.5% rate depending upon the other qualifying factors.

However, if that incomes passes from an underlying discretionary trust shareholder to a corporate beneficiary it will be taxed at 30% as it will NOT be a "non-portfolio" dividend and 100% of the income is BREPI.

[37] However it is important to note that s,588V and s.588W of the Corporations Act 2001 (Cth) may allow the trading subsidiary company's liquidator to recover from the holding company, as a debt due to the trading subsidiary company, an amount equal to the amount of the loss or damage suffered by a person as a result of the trading subsidiary company incurring debts whilst insolvent.




## Con: Use of asset potentially triggers s.109CA payment

A potential "con" of using a corporate trading entity is the need to carefully monitor the potential application of section 109CA of ITAA 36. In its simplest form, section 109CA provides that the provision of an asset for use by an entity constitutes a payment to that entity for the purposes of section 109C of ITAA 36.

The ATO provide 14 different examples of the operation of section 109CA in their website guidance.[38] Example 4 provides a clear stark example of the breadth of the potential application of the section where simply the availability of a motor vehicle to a shareholder or an associate of a shareholder is enough to trigger the operation of the section.

> **Example 4 – provision of assets for use by shareholders**
>
> Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.
>
> **Peter's use of the car that he takes home will be subject to Division 7A**. This will include **driving** the car (actual use) and the **availability** of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.
>
> Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are not available to Peter to the exclusion of the company.

## Con: Capital extraction problematic

In addition to the tax management matters for corporates addressed above at paragraph **Error! Reference source not found.**, companies need to be mindful that extracting capital will trigger one of a number of potential taxing points. Whether that is as simple as an immediate section 109C payment or a taxation liability as a result of the quasi "profits first" type rule sin profits first" rules arising as a result of franked and unfranked dividends, capital reductions, buy-backs, liquidations and the operation of section 45B ITAA 36.

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[38] Refer to https://www.ato.gov.au/Business/Private-company-benefits---Division-7A-dividends/In-detail/Division-7A---Use-of-assets/

In relation to section 45B ITAA 36 the ATO addressed the argument that it operates as a "profits first" type rule and although they denied that in paragraph 33, they then noted at paragraph 34 that it by implication "does presuppose some objective non-tax basis for distributing capital".

Practice Statement Law Administration (PSLA) 2008/10 states:

> 33. Section 45B is not a 'profits first' rule. It is a sanction against schemes to provide shareholders with capital benefits, including distributions of share capital, which were entered into or carried out for a significant purpose of enabling the shareholder to benefit from receiving preferentially taxed capital rather than profit.
>
> 34. **However**, although section 45B does not apply on a profits first basis, **by implication it does presuppose some objective non-tax basis for distributing capital** rather than profits, where both are available. Essentially, profits are a gain to the company which, when surplus to the company's needs, are meant to be divided amongst the shareholders; hence the word 'dividend'. Share capital, on the other hand, is the money contributed by the company's members for carrying out its objects until some event or circumstance renders its retention unnecessary, whereupon it may be returned.

## Con: Need to consider s.109T

There are **three** basic conditions that need to be satisfied for section 109T to be applied (in very broad terms):

- a private company makes a payment or loan to another entity (the **interposed entity**) that is interposed between the private company and the **target entity** (and the payment or loan is not a deemed dividend under 109C or 109D);
- a **reasonable person would conclude** (having regard to all the circumstances) that the private company made the payment or loan solely or mainly as part of an arrangement involving a payment or loan to the target entity; and
- either the interposed entity or another interposed entity makes a payment or loan to the target entity.

It does not matter if the payment or loan to the target entity is of the same amount or before, after, or at the same time as that to the interposed entity.

109V and 109W, treats the payment or loan as from the private company to the target entity.

## Taxation Determination TD 2018/13

The ATO recently released Taxation Determination TD 2018/13 (**TD 2018/13**) confirming its view that the (often overlooked) interposed entity provisions in section 109T of Division 7A of ITAA 36 can apply to ordinary commercial transactions.

The ATO released TD 2018/13 in draft as TD 2017/D3 (the **Draft**) in 2017 and the final Determination includes a compendium (**TD 2018/13EC**) that includes ATO responses to issues raised by external parties on the Draft.

The ATO view in TD 2018/13 is that a payment or loan made by a private company to another entity (the 'first interposed entity') in an ordinary commercial transaction can trigger Division 7A. This will be the case when the ATO considers a reasonable person would conclude (having regard to all the circumstances) that the payment or loan to the first interposed entity is made solely or mainly as part of an arrangement involving a payment or a loan to a shareholder or shareholder's associate (the 'target entity') of the private company.

Under section 109T, Division 7A operates as if the private company made the payment or loan directly to the target entity.

The ATO states that a payment or loan made by a private company to the first interposed entity which results in

Division 7A treating the amount as a dividend to the first interposed entity is the **only** kind of transaction between private company and interposed entity to which subsection 109T(1) cannot apply.

Therefore, every transaction outside this scope will require taxpayers to consider whether the reasonable person test outlined in subsection 109T(1)(b) is satisfied, regardless the loan or payment being an ordinary commercial transaction.

Regarding the reasonable person test, the ATO states:

> If a reasonable person would conclude (having regard to all the circumstances) that the private company made the payment of the section 44 dividend to the first interposed entity solely or mainly as part of an arrangement involving a payment or loan to the target entity, neither of the following factors prevents Subdivision E of Division 7A from applying:
>
> (a) that the payment of the section 44 dividend is an ordinary commercial transaction, or
>
> (b) that all, or some, of the amount of the payment of the section 44 dividend is included in the first interposed entity's assessable income.

Submissions on the Draft included that the Explanatory Memorandum for the introduction of Division 7A did not state that the payment of an actual dividend can enliven section 109T. The ATO response in TD 2018/13EC is that the Explanatory Memorandum stated:

> "… that Division 7A applies to all distributions of profit 'unless they come within specified exclusions'. There is no provision that excludes (specifically or otherwise) a payment of a dividend to which section 44 applies from forming part of an arrangement to which section 109T applies."

Furthermore, sections 109U and 109UA of Division 7A consider arrangements where a private company guarantees third party loans to a shareholder or an associate and:

> "it would be anomalous for Parliament to have specifically recognised and dealt with schemes associated with such interposed private companies in relation to the specific arrangements under consideration therein, but not have contemplated the same schemes in relation to the general operation of section 109T."

Submissions on the Draft also raised concerns on whether the application of section 109T would result in double taxation, as it is contrary to the purpose of Division 7A and established principles of statutory interpretation. The Commissioner's response was:

> "… while the reasonable person test in paragraph 109T(1)(b) requires that every case be considered having regard to its facts and circumstances, the Commissioner agrees with the general proposition that the total tax payable on the relevant amount of private company profits should be limited to the amount payable if assessed at the target entity's marginal tax rate. However, the Commissioner reserves the right to apply Division 7A on a different basis depending on the nature of the arrangement under consideration."

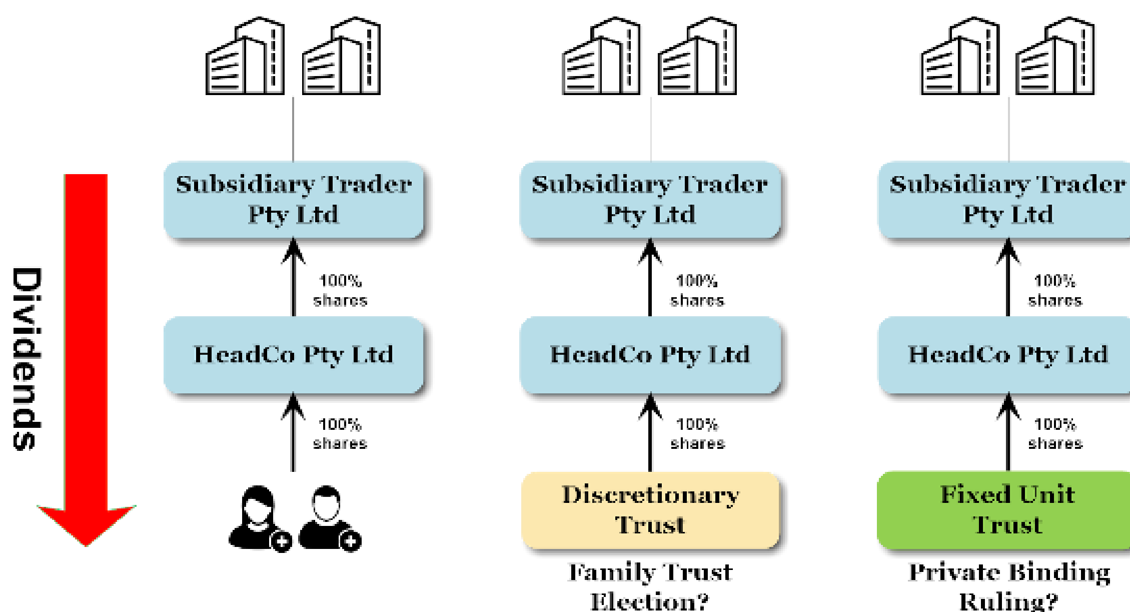
Contrary to submissions that TD 2018/13 should apply prospectively from the date of issue, TD 2018/13 applies to years of income beginning both before and after its date of issue.

However, the ATO did go some way to addressing concerns in submissions on the Draft that 'ordinary family transactions' may be caught by section 109T. TD 2018/13 does this by including two additional examples (examples 6 and 7) where the Commissioner would reduce the amount of the deemed payment or loan (resulting from a technical application of section 109T) to nil.

The ATO views in TD 2018/13 reinforces the need for taxpayers contemplating transactions between entities within a family group to consider the application of Division 7A (and section 109T) before undertaking those transactions.

# Trusts as the company shareholder – the franking credit issues

## Franking Credits – The Issue for Trusts




Previously specific rules were contained in Division 1A of Part IIIAA of ITAA 36 (**Division 1A**) in respect of the ability for franking credits attached to franked dividends to flow through a trust to its beneficiaries. However, Division 1A was repealed with effect from 1 July 2002.

In its absence, it has become practice of the ATO that the legislation may continue to apply. It was noted at paragraph 9 of Taxation Determination TD 2007/11:

> The very wording of sections 207-145 and 207-150 makes it clear that regard is to be had to the rules in Division 1A in determining whether a person is a qualified person for the purposes of these provisions in respect of a franked distribution, irrespective of whether the distribution is made after 30 June 2002. There is nothing in the relevant extrinsic material to indicate the contrary.

Broadly, subject to small shareholder exception ($5,000 of franking credits from all sources), a taxpayer may only claim franking credits if it is a "**qualified person**" in relation to the franked dividend. In order to be a qualified person a taxpayer must satisfy two rules:

- the related payments rule; and
- the **holding period** rule.

The related payments rule requires the beneficiary (or associate) not to make a payment that transfers the economic benefit of a dividend to another person.

The holding period rule requires a beneficiary to have held its interest in the shares for a continuous period of not less than 45 days. In calculating the number of days for which a beneficiary continuously held the interest in shares, any days on which the beneficiary acquired or disposed of the interest and the days on which the beneficiary had materially diminished risks of loss or opportunities for gain in respect of the interest, are not taken into account.

Generally, a beneficiary is taken to have materially diminished risks of loss or opportunities for gain on a particular day in respect of an interest in shares if the beneficiary's net position on that day in relation to the interest has less than 30% of the risks and opportunities.

A beneficiary's interest in shares is worked out using the formula in former s.160APHL. Former subsection 160APHL(7) provides that a taxpayer's interest determined under the formula has a long position with a delta of +1 in relation to itself.

## Former subsection 160APHL(10)

Former subsection 160APHL(10) specifies an additional position in certain circumstances. Broadly, where the trust has **not** made a family trust election (**FTE**) a beneficiary of a trust, will be taken to have a short position equal to its long position and a long position equal to so much of the beneficiary's interest in the trust as is a fixed interest. Therefore, in a simple single family unit utilising a single discretionary trust shareholder, it may be easy to make an FTE and then not have to be concerned with the ability to access the franking credits. However, where the trust shareholder is a unitised type entity with multiple family investors the **question of there being a fixed interest becomes critical**.

Former subsections 160APHL(10) and 160APHL(11) provides as follows:

**160APHL(10) Additional positions of the taxpayer.**

If:

(a) the trust is **not a family trust** within the meaning of Schedule 2F; and

(b) …; and

(c) …;

the taxpayer has, in addition to any other long and short positions (including the positions that the taxpayer is taken to have under subsection (8)) in relation to the taxpayer's interest in the relevant share or relevant shares, **a short position equal to the taxpayer's long position** under subsection (7) and a **long position equal to so much of the taxpayer's interest in the trust holding as is a fixed interest**.

**160APHL(11) A vested and indefeasible interest constitutes a fixed interest.**

For the purposes of subsection (10), the taxpayer's interest in the trust holding is a **fixed interest to the extent that the interest is constituted by a vested and indefeasible interest** in so much of the corpus of the trust as is comprised by the trust holding.

Beneficiaries having no fixed interest will have a net position of zero (which is less than 30%) and materially diminished risks of loss and opportunities for gain for the entire test period and therefore cannot satisfy the holding period rule.

## Fixed Entitlement - Case Law

The basic requirement for a beneficiary's interest in a trust to be considered a fixed entitlement is that the beneficiary has a vested and indefeasible interest in a share of income of the trust that the trust derives from time to time, or in the capital of the trust. Practically speaking this means that the interest should not be able to be defeated by the action of one or more persons or by the occurrence of one or more subsequent events.

Various decisions of the courts have questioned the ability to establish any unit trust as allowing beneficiaries as having a vested and indefeasible interest in the trust. In Decision Impact Summary - *Kafataris v. DCT* [2008] FCA 1454 the ATO notes in respect of 'absolute entitlement':

> … To be absolutely entitled to an asset as against the trustee, the beneficiary must have both a vested and an indefeasible interest in the asset and be able to demand transfer of the asset by the trustee.
>
> …In particular, the presence in the particular deed of a clause that gives the trustee power to sell and vary investments, will be inconsistent with the existence of absolute entitlement …

## *Colonial First State Investments Ltd v. COT* [2011] FCA 16

Further, in Decision Impact Summary - *Colonial First State Investments Ltd v. COT* [2011] FCA 16 the issue facing the court was whether the Wholesale Fund was a fixed trust for the purposes of section 272-65 in Schedule 2F (the fixed entitlement issue).

The Court found that the Wholesale Fund was not a 'fixed trust' for the purposes of section 272-65 of Schedule 2F as the interests of unitholders in income and capital of the trust were defeasible. Ultimately the Court held that the interests of unitholders in income and capital of the Wholesale Fund could be defeated by the unitholders exercising the powers granted to them under paragraph 601GC(1)(a) of the Corporations Act 2001 to modify, replace or repeal the constitution by special resolution. [paragraphs 103-106]

The ATO's view on this case is that it confirms the view that very few trusts satisfy the definition of 'fixed trust' in section 272-65 of Schedule 2F in the absence of the exercise of the Commissioner's discretion (essentially because beneficiary entitlements to income or capital are generally liable to be defeated by the exercise of a power in the deed or by a statutory power).

The ATO has previously considered issuing a public ruling about the fixed entitlement test in the trust loss provisions in Schedule 2F. The ATO has previously concluded that, even on a purposive and contextual interpretation of the actual words used in the legislation, an interpretative position could not be reached that aligned with industry expectations. The indefeasibility requirement was significant in that respect.

## Practical Compliance Guideline (PCG) 2016/6

Attachment A to PCG 2016/16 (originally published as attachment A to Practice Statement Law Administration PS LA 2002/11) provides a list provisions affected by the meaning of "fixed entitlement" in s 272-5 of Sch 2F ITAA 36. This includes franking of dividends under sections 160APA and 160APHD. In response to the practical problems created by decisions of the courts in considering the meaning of "fixed entitlement" the ATO published PCG 2016/16 and noted in the introduction to the PCG that:

> 1. This Guideline outlines the factors the Commissioner will consider when deciding whether to **exercise the discretion** to treat an interest in the income or capital of a trust as being a fixed entitlement. This **can result in a trust being treated as a fixed trust** under the trust loss provisions and is also relevant when applying other provisions in the tax legislation which rely on the concept of **'fixed entitlement'** (listed in Attachment A of this Guideline).

2. In practice, it may be difficult for many trusts to satisfy the definition of 'fixed trust' **unless the Commissioner exercises his discretion** to treat the beneficiaries' interests as fixed entitlements.

3. This Guideline also outlines (at Attachment B) a **safe harbour compliance approach** for trustees of certain trusts that allows them to manage the trust's tax affairs as if the Commissioner had exercised the discretion to **treat beneficiaries as having fixed entitlements** to income and capital of the trust.

The safe harbour compliance approach for trustees of certain trusts that allows them to manage the trust's tax affairs as if the Commissioner had exercised the discretion only applies to determinations made in accordance with section 272-5 of Sch 2F ITAA 36. There is a similar discretion that allows the Commissioner to determine an interest to be vested and indefeasible in accordance with the franking credit rules. Former subsection 160APHL(14) provides as follows:

**160APHL(14) Commissioner may determine an interest to be vested and indefeasible.**

If:

(a) the taxpayer has an interest in so much of the corpus of the trust as is comprised by the trust holding; and

(b) apart from this subsection, the interest would not be a vested or indefeasible interest; and

(c) the **Commissioner considers** that **the interest should be treated as being vested and indefeasible**, having regard to:

(i) the circumstances in which the interest is capable of not vesting or the defeasance can happen; and

(ii) the likelihood of the interest not vesting or the defeasance happening; and

(iii) the nature of the trust; and

(iv) any other matter the Commissioner thinks relevant;

t**he Commissioner may determine that the interest is to be taken to be vested and indefeasible**.

However, PCG 2016/6 does not address this provision.

## Joint submission on Draft PCG 2016/D16

The industry bodies made a submission in respect of the draft form of PCG 2016/6 noting that it would be efficient if the PCG dealt with former subsection 160APHL(14).

The submission noted that the wording of the discretion in former subsection 160APHL(14) is very similar to the Commissioner's discretion under subsection 272-5(3). It is also identified and accepted that it may be difficult to exercise the discretion where the relevant class has no right to capital. However, there was no reason why the Commissioner should not exercise his discretion under former subsection 160APHL(14) in circumstances where all beneficiaries have a consistent proportionate entitlement to dividends and capital gains from the shares in a trust and those entitlements are effectively not discretionary.

Despite the submission, the final form of PCG 2016/6 explicitly addresses former subsection 160APHL(14) and confirms that the PCG does not apply to that provision.

4. This Guideline does not apply:

For the purposes of applying former subsection 160APHL(14) of the ITAA 1936 (about the holding period rule for franking credits).

## Solution to the franking credit problem with unit trusts?

Where a trust holds shares in a company the trustee needs to give consideration to either:

1. making an FTE (where possible); or
2. seeking a private binding ruling from the Commissioner where the Commissioner agrees to exercise his discretion under former subsection 160APHL(14) to determine that the interests under the trust are to be taken to be vested and indefeasible;

in order for the beneficiaries of the trusts to access the franking credits arising from distributions of the franked dividends made by the company through its trust shareholder.

# Conclusion

Choosing an appropriate alternative investment vehicle to a self managed superannuation fund involves the need to consider a range of issues. These issues address the asset protection, taxation and flexibility of the structure. However, as explored in this paper there are a range of additional issues that need to be considered including the administrative complexity of the structure, the succession planning opportunities of the structure and the structure's role as a "building block" in a larger group or multi-family investment.

Ultimately the appropriate structure in any given circumstance will be the result of a careful balancing of the advantages and disadvantages of the structure matched with the objectives of the client group. Also, even where a particular structure is adopted, care must be taken to carefully consider the documents that create the structure to ensure that they achieve the outcome sought. Particularly in the case of trust structures, the terms of the deed may result in significant material differences to that intended if the deed is not carefully prepared.

Whilst the challenges are great, the opportunity to work closely with client groups to best achieve their investment objectives can be very rewarding.

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