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Trusts at risk of incorrect distributions with significant tax consequences

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Understanding the definition of 'income' for trusts has always been important. However, for 30 June 2020, it has been more critical than ever due to the coronavirus (COVID-19) pandemic. The Australian Taxation Office (ATO) retains its view that trusts must determine a cap on the 'income of the trust estate' that can be distributed to beneficiaries under draft ruling TR 2012/D1 *Income tax: meaning of 'income of the trust estate' in Division 6 of Part III of the Income Tax Assessment Act 1936 and related provisions* (TR 2012/D1). Failure to consider these issues may result in a risk of having no income of the trust estate (potentially resulting in a trustee assessment of 47%) or grossly under or overestimating the income of the trust (potentially resulting in taxpayers being attributed more or less taxable income for the year under the proportionate approach).

Further, COVID-19 may result in restrictions being placed on unpaid present entitlements (UPEs) or requirements to refinance. Both of these issues can result in a trustee assessment. As distribution resolutions had to be made before the end of the financial year, these issues must have been identified and dealt with as part of year-end planning.

Background

A beneficiary is generally liable to pay tax on their proportionate share of a trust's net (taxable) income. This is determined by calculating the share of the 'income of the trust estate' to which the beneficiary is presently entitled (otherwise referred to as the "distributable income" of the trust).

While there has been much debate on how to determine the distributable income in the past, COVID-19 has brought into focus a number of key issues that had to be considered as part of year-end planning. As trust distribution resolutions were required by 30 June 2020, significant tax may become payable if these issues were not considered and addressed before year end.

What are the risks of getting distributable income wrong?

Getting the distributable income amount wrong can result in:

1. tax being payable by the trustee at the top marginal tax rate (e.g. where the trust has no distributable income)
2. beneficiaries being liable for a higher than expected proportion of the trust's net (taxable) income
3. the need to deal with disclosure of any difference between accounting and taxable income in the financial statements.

How is distributable income calculated?

Generally, where the income of the trust estate is determined in accordance with trust law concepts, the amount is determined having regard to generally accepted accounting principles.¹ Accordingly, if proper accounts are kept in line with this principle, the amount recorded in the profit or loss statement would generally be a good starting point in determining income of the trust estate.

This concept does not allow for 'creative accounting', as court decisions have looked to determine the appropriate accounting treatment for the purposes of ascertaining the income for trust law purposes. For 30 June 2020, the accounting profit may have been impacted by a number of provisions that had to be recorded (for instance, asset impairments), which could have resulted in there being no amount of income under ordinary concepts.

In other cases, the trust deed may have a clause that essentially equates income of a trust (as defined in the trust instrument or by the trustee acting in accordance with a power granted under the trust instrument) to the net income of the trust within the meaning of section 95 of the *Income Tax Assessment Act 1936* (ITAA 36) (an 'income equalisation clause'). This can have the effect of increasing the distributable income beyond the extent of the trust's realisable assets or net assets available for distribution.

What does TR 2012/D1 say about calculating distributable income?

In TR 2012/D1, the Commissioner considers three principles that apply in relation to the distributable income. These are that the income of the trust estate must be:

1. *measured in distinct years of income,*
2. *a product of the trust estate, and*
3. *an amount a beneficiary can be presently entitled to.*

These principles are supported by various cases, and we believe that these concepts are broadly defensible.²

However, in determining the 'amount' for the purposes of principle 3 above, the ATO has established a complex methodology of calculating a cap on distributable income that may be (in part) somewhat questionable. However, the ATO's view remains, and ignoring this view may result in future disputes. TR 2012/D1 outlines the Commissioner's view that the income of the trust estate cannot exceed (that is, places a cap on the distributable income of) the sum of:³

- accretions to the trust estate (of property, cash or value)
- less accretions to the trust estate that have been allocated to capital, and
- less depletions to the trust estate that have been allocated to income.

What are the consequences of a limit to the distributable income?

The tax consequences of the ATO applying TR 2012/D1 to limit the amount of the distributable income of the trust can be significant in certain cases. For instance,

where year-end resolutions are drafted on a quantum, rather than a proportionate, basis, the ATO's view can reduce the overall distributable income, resulting in a higher or lower proportion of income being attributed to beneficiaries. This can result in more tax being payable by those beneficiaries.

Moreover, if the cap results in the trust having no distributable income, excess franking credits may be trapped in the trust, or the trustee may be required to pay tax at the top marginal tax rate on the trust's net (taxable income).

In addition, where the net distributable income of the trust (that is required to be distributed) exceeds the reported accounting income in the financial statements, the difference may need to be dealt with in the accounts, and could cause the trust to go into a negative net asset position (or compound an existing negative net asset position).

What happens when there are permanent differences?

One may find that there were permanent differences recorded for 30 June 2020. Illustrations include provisions for impairments of capital assets held on capital account or non-deductible legal costs. These items may be recorded as an expense for accounting purposes but may not amount to a tax deduction. Accordingly, accounting income may be less than taxable income in these cases. This is demonstrated in Example 1.

Example 1

Assume that the Brisbane Family Trust derived \$50,000 in rental income from its various residential properties during the 30 June 2020 income year. The trustee also incurred \$10,000 in legal fees that were not deductible for tax purposes, resulting in an overall accounting profit of \$40,000 and taxable income of the trust equal to \$50,000. Before 30 June 2020, the trustee resolved to distribute the whole of the distributable income of the trust to Robert, an adult resident beneficiary.

Analysis and discussion of example

This example outlines a concern mainly where there is an income equalisation clause in the deed. In such a case, the effect of the deed is that the rental receipts (but not the legal expenses) would be included in calculating the distributable income of the trust. Accordingly, the distributable net income of the trust would first be equal to \$50,000.

TR 2012/D1 would not appear to limit the amount of the distributable income to less than the accretion (\$50,000) as the legal expenses, while a depletion of the trust estate, are treated as capital expenses under the trust deed.



The quote

It may be possible that the trust deed allows for non-deductible expenses (that are recorded in the profit and loss statement) to be allocated against 'income' and thus be taken into account in determining the distributable income for the year.

Therefore, under the resolution, Robert would be entitled to \$50,000 of trust income (and would be liable for tax on the whole amount). The trustee would need to account for the excess \$10,000 entitlement that arises as a result of the income equalisation clause, which in effect reduces the corpus of the trust by \$10,000 and may result in net assets being a negative amount.

If the trustee is required to distribute \$50,000 in this case (being the distributable income), this will result in the trust having a deficiency of assets, relative to the start of the year, equal to \$10,000. This is represented by the expenses that have been applied as a capital amount. The accounts would need to record the distribution of the whole of the income of the trust estate.

What happens when there are large timing differences due to COVID-19?

One may also find that there are large timing differences that must have been recorded for 30 June 2020. Illustrations include provisions for debt write-downs, provisions of impairment of investment values or provision for non-collectability of income derived (such as rental income under a contract). Most of these items may have been recorded as an expense for accounting purposes but may not have amounted to a tax deduction in the 30 June 2020 income year. Accordingly, accounting income may be significantly less than taxable income in certain cases. This is demonstrated in Example 2.

Example 2

Assume that the Brisbane Family Trust had taxable income of \$100,000 for the 30 June 2020 income year but, after adjusting for accounting provisions, there was an accounting loss of \$50,000. Before 30 June 2020, the trustee resolved to distribute the whole of the distributable income of the trust to Robert, an adult resident beneficiary.

Analysis and discussion of example

This example presents two problems. If the trust deed defines income according to trust law concepts, then there may be no income to distribute to beneficiaries. Accordingly, Robert may be entitled to no amount and the trustee may pay tax at 47%.

Alternatively, if the trust deed has an income equalisation clause, the trust may need to distribute \$100,000, even though there is no accounting profit. As with Example 1, TR 2012/D1 may not result in a cap being applied in this case as the non-deductible expenses are likely to be treated on capital account by virtue of the trust deed only including 'deductible' amounts as part of the determination of income of the trust. This may require the trustee to distribute \$100,000 to Robert under the resolution, which may result in a further deficiency of assets equal to this distributable amount.

Can this issue be managed?

It may be possible that the trust deed allows for non-deductible expenses (that are recorded in the profit and loss statement) to be allocated against 'income' and thus be taken into account in determining the distributable income for the year.

In Example 1, assuming that the clause in the trust deed allows

the trustee to validly recharacterise the expense, this could allow the trust income to be reduced to \$40,000.

In Example 2, under the 'ordinary income' deed this could also allow some of the expenses to be recharacterised as being on capital account, so that there is at least some amount of income to distribute to Robert.⁴ Alternatively, under the income equalisation clause deed a recharacterisation of expenses from capital to income may enable the trust to reduce the distributable amount, and thus the extent of the deficiency caused by a distribution.

Care must be taken with this approach. For instance, an over recharacterisation of capital expenses to income account could result in there being no 'income of the trust estate', even though the trust has taxable amount for the year (such that it would be assessable to the trustee). Further, careful examination of the trust deed would be required, as there are often limitations on the recharacterisation clause. For instance, it may only apply to payments, which could allow the 'legal expenses' to be recharacterised but may not allow 'market value movements' to be recharacterised.⁵

What happens if restrictions are placed on paying entitlements?

As a result of COVID-19, financial institutions may request that restrictions be placed on unpaid entitlements (both new and existing). One should be mindful of any restrictions that may be imposed on the trustee. A present entitlement is a present legal right of a beneficiary to demand and receive the payment of income. Adding restrictions to a present entitlement may give rise to issues of the validity of a trust distribution for income tax purposes.

In such cases, consider whether this situation is overcome by refinancing UPEs as loans by way of legal offsets between the trust and the beneficiary (for instance, by the beneficiary agreeing to lend the amount to the trust and setting-off this promise against the trust's obligations under the present entitlement).⁶

This is because restrictions on a loan account (that is, debt subordination) do not affect the ability for the beneficiary to receive payment of the present entitlement, which would have already been satisfied by way of refinancing into a loan.

However, other issues should be considered in a refinancing case, including Division 7A of the ITAA 36 (for any changes that are made to UPEs) as well as the trust stripping provisions (for instance, section 100A of the ITAA 36, which could have applied if the reimbursement agreement, being the refinancing, was arranged prior to 30 June 2020).

What other issues should a trustee consider?

Where a trust has negative assets and external liabilities, trustees may need to consider issues with the administration of the trust, such as questions of solvency and whether it is in the best interests of the beneficiaries of the trust to pay trust distributions or pay creditors of the trust.

Trustees may also need to consider whether income of the trust needs to be first applied to make good losses incurred as a result of COVID-19, or whether instead it can be distributed to beneficiaries (for instance, the rule in *Upton v Brown* (1884) 26 Ch D 588). To the extent that a trustee is concerned with making distributions to beneficiaries for 30 June 2020, we recommend that the trustee seeks legal advice. Beneficiaries may need to consider refinancing their UPEs as subordinated debt (via a repayment of the debt) as outlined earlier.

It is critical to consider one's position and how the rules may apply to one's circumstances. **FS**

Notes

1 *Zeta Force Pty Ltd v FC of T* [1998] FCA 728.

2 However, there is some concern about the extent to which amounts that form part of the trust estate at the start of the year can be taken to be income derived by the trust during the year (see comments by the ATO in paragraphs 11 and 92 of TR 2012/D1).

3 See paragraph 13 of TR 2012/D1.

4 Robert should then be taxed at his marginal tax rate on the whole of trust's net (taxable) income as he is entitled to 100% of the income of the trust estate.

5 Most modern deeds allow the trustee to determine whether market value movements are treated on income or capital account. See, for example, the decision in *Clark v Inglis* [2010] NSWCA 144.

6 See, for example, *East Finchley Pty Ltd v Commissioner of Taxation* [1989] FCA 720.