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Trust distribution resolutions, are yours effective?

PEARSON V COMMISSIONER OF TAXATION [2006] FCAFC 111

INTRODUCTION

An important practical task that tax practitioners must address each year is whether or not their trustee clients need to make a resolution to distribute income, and perhaps separately distribute capital gains, to their respective beneficiaries. To answer this question a tax practitioner must, at the very least:

a) read the relevant trust deed to determine who the beneficiaries are, and whether a distribution resolution is required; and
b) determine whether or not the trust has derived any accounting income calculated by reference to the general law and the terms of the trust deed.[1]

Most discretionary trust deeds contain a default beneficiaries clause, which operates to automatically appoint income to certain beneficiaries if the trustee does not make a deliberate decision in regard to that income. If there is no default beneficiary clause, or if the clause is ineffective, and no trust distribution resolution has been made, no beneficiary will be presently entitled to the income of the trust estate. The effect of this is that the trustee will be taxed on the taxable income of the trust under s 99A of the *Income Tax Assessment Act 1936 (Cth)* ("ITAA36").

Similarly, most unit trust deeds are "self-executing" such that the unit-holders are automatically entitled to the net income of the trust in proportion to their interest in the trust. In *Pearson v Commissioner of Taxation* [2006] FCAFC 111 (*"Pearson"*), the Court provided instructive discussion in relation to whether a beneficiary of a unit trust is presently entitled to a share of the income of a trust estate. The decision in Pearson considers two trust deeds, one of which was self executing and one of which required the trustee to, during the month of June in each year, *decide the amount (if any) of the net income of the fund to distribute.*

FACTUAL BACKGROUND

The Taxpayer and her husband were the primary beneficiaries of the Jancy Trust, of which Jancy Pty Limited was the trustee. The Jancy Trust held all of the issued units in the Corplan Financial Group Unit Trust (CFGUT). The Jancy Trust also held all of the units in the Corplan Financial Network Unit Trust (CFNUT).

Between 1992 and 1994, in its capacity as trustee, Jancy resolved to distribute to the Taxpayer:

- 50 percent of the 1992 net income,
- the first $9,000 and 50 per cent of the balance of the 1993 net income, and
- 100 percent of the 1994 net income.

The trust deeds for CFGUT and CFNUT differed in the way they provided for the distribution of income to beneficiaries. The deed of CFNUT contained a self executing clause that resulted in beneficiaries being entitled to income distributions without the trustee having to make a resolution to distribute income to them. However, the deed of the CFGUT required the trustee either to resolve to distribute income to the beneficiaries[2] or to accumulate.

After the lodgment of the Taxpayer's income tax returns for the relevant income years, the Commissioner issued amended assessments in respect of the CFNUT and CFGUT. In turn, the net income of the Jancy Trust was increased by a total of $3,295,788. As a consequence, the Commissioner also issued amended assessments to the Taxpayer and her husband. After unsuccessfully objecting to these amendments, the Taxpayer appealed to the Federal Court.

ISSUES

TAXPAYER'S SUBMISSIONS

The Taxpayer argued before the Full Federal Court that she was not required to include, as part of her assessable income, her share of the net income of the CFNUT or the CFGUT on the basis of the High Court's decision in *CPT Custodian v Commissioner of State Revenue*[3] *("CPT Custodian")* which had been handed down since the judgment at first instance. The Taxpayer argued that notwithstanding that the Jancy Trust had resolved to make distributions to the Taxpayer, she was not liable for tax on the net income of the CFGUT and the CFNUT as the Jancy Trust was not "presently entitled" to that income.

CPT Custodian

In CPT Custodian the trustee was the registered proprietor of real property. The issue for consideration was whether the unit-holders in a unit trust were owners of the land that the trustee held as a registered proprietor. The Victorian Commissioner of State Revenue argued that a unit-holder of a land-holding unit trust was the beneficial owner of the land because the unit-holders could bring to the trust to an end in reliance on the rule in *Saunders v Vautier*. This rule provides that where all the beneficiaries of a trust estate are sui juris, and they all call for the trust assets to be vested, then the trust fund will be determined. Applying that rule, the Commissioner argued that the unit-holders were therefore owners of the land for the purpose of the *Land Tax Act 1958 (Vic)* and liable to land tax.

The High Court disagreed with the Commissioner of State Revenue. In coming to this conclusion the High Court affirmed the views of Nettle J, at first instance, that a trust deed generally provides the trustee with the power to incur expenses and acquire other assets from the income received by a trust fund. Therefore all that a unit-holder is entitled to receive from the trust fund is the *net income* of that fund. Furthermore, the High Court held that the rule in *Saunders v Vautier* did not apply to CPT Custodian as the unit-holders were not the only persons to whom the trustee might apply the trust property. The High Court in *CPT Custodian* held that the rule in *Saunders v Vautier* does not apply where a trust has liabilities, including liabilities to a trustee under the right of indemnity, or reimbursement, for any liabilities the trustee has incurred in administering the trust. In this regard, the High Court held that where a trustee is entitled to be reimbursed, the sui juris beneficiaries are only entitled to an undetermined and uncertain surplus (if any) of the trust fund and therefore it is impossible to determine what each beneficiary is entitled to.

According to the Taxpayer in *Pearson*, no present entitlement exists as the trustees of both the CFNUT and the CFGUT were entitled to a reimbursement for any liabilities it had incurred in the administration of the trust estate. Therefore, applying the High Court's decision in *CPT Custodian*, both trusts were not exclusively for the benefit of the Jancy Trust (the sole unit-holder). Consequently the rule in *Saunders v Vautier* was not applicable and the Taxpayer was not required to include the net income of the two trusts as part of her assessable income.

THE COMMISSIONER'S SUBMISSIONS

The Commissioner argued that as the "self-executing" clauses in the CFNUT trust deed rendered the Jancy Trust presently entitled to the net income of that trust and the Taxpayer is therefore required to include her share of that net income in her assessable income. Furthermore, the Commissioner argued that the High Court's decision in *CPT Custodian* is not applicable as the trustee's right to reimbursement in that case was evidenced in the accounts and so the debtor-creditor relationship was established. In CFGUT's case, no liabilities were recorded in the accounts. Accordingly, the rule in *Saunders v Vautier* applied in relation to CFGUT, rendering the Jancy Trust presently entitled to the net income of CFGUT.

DECISION OF THE FULL FEDERAL COURT

The Full Federal Court held that the Jancy Trust was presently entitled to the net income of CFNUT, however, it was not presently entitled to the income of CFGUT. In reaching its decision, the Court referred to *Harmer & ors v Commissioner of Taxation* (1991) 173 CLR 264 where it was affirmed that a beneficiary is presently entitled to income of a trust estate under Div 6 of Part III of the ITAA36 if:

- that beneficiary's interest in the income is both vested in interest and vested in possession; and
- the beneficiary has a present legal right to demand and receive payment of the income.

In regard to CFGUT, the Full Federal Court held that the Taxpayer was not presently entitled to the net income of the trust because the trust deed was not self-executing. For the Jancy Trust to be presently entitled to the income of CFGUT, the trustee of CFGUT must make a resolution on or before 30 June in favour of the Jancy Trust. As no such resolution had been made (due to the belief that CFGUT had made a loss in the relevant year and therefore had no income to distribute), the Jancy Trust did not have a present legal right to demand and receive payment of the net income of CFGUT that was later found during the ATO audit. Accordingly, the Taxpayer was not required to include her share of the net income of CFGUT as part of her assessable income.

However, the Full Federal Court held that the effect of the self-executing clause in the trust deed of CFNUT is that the Jancy Trust had both a vested interest and possession of the income of the CFNUT. The Jancy Trust was therefore presently entitled to the whole of the net income of CFNUT in the relevant income years. The effect of this is that the s 95 income of CFNUT for each of the relevant years was to be included in the s 95 income of the Jancy Trust. Furthermore, as the Jancy Trust had resolved to distribute some of its net income to the Taxpayer, the Taxpayer was therefore required to include that income as part of her assessable income.

CONCLUSION

As noted by Edmond J, a determination of tax liability will ultimately turn on the terms of the constituent document and the circumstances of the particular case. Whilst the terms of the trust deed will remain the same, the trust's circumstances will change from time to time. It is therefore imperative that practitioners consider what they are doing and tailor-make each trust distribution resolution. It is also worth noting that as a matter of trust law, the trust deed will operate according to its terms, therefore a trustee should invariably make a distribution decision before midnight 30 June each year. This is notwithstanding the Commissioner's administrative practice of accepting a trustee's resolution made before the end of August. This is because, for example, if default beneficiaries exist they will automatically become presently entitled to the income at the end of the year, even if they are not the intended beneficiaries when a resolution is made at a later date, in reliance on the Commissioner's grace period.

In *Pearson*'s case there were two different trust deeds and it appears that the advisors might not have understood the different tax outcomes of each deed, on similar facts. The outcome in *Pearson* is only one example of what can go wrong when a tax practitioner has not read and understood the trust deeds. While the Taxpayer would have welcomed the Full Federal Court's decision in regard to CFGUT, we assume that the trustee will, in due course, receive a s 99A assessment for the income that has been accumulated. In light of *Pearson* and the possibility of the Commissioner issuing an amended assessment, trustees should make a trust distribution resolution each year irrespective of the trust making a loss.

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Reference notes

1 *s 97(1)(a) ITAA36.*

2 *Clause 22.*

3 *CPT Custodian Pty Limited (previously trading as Sandhurst Nominees (Vic) Ltd) v Commissioner of State Revenue (2005) 221 ALR 196.*