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BAMFORD'S CASE- PRIVATE FAMILY TRUSTS- ARE YOU AT RISK?

It is not uncommon for small business operators to have what are known as private family trusts. Generally these fall into two categories, either family discretionary trusts or private unit trusts.

A trust (Trust) relationship exists where a person or company (Trustee) holds investments, money or property (the Trust Fund) for others (the Beneficiaries). The powers and obligations of the Trustee and the rights and interests of the Beneficiaries are often recorded in a Trust Deed. There are also very specific laws that apply to Trust relationships which are largely aimed at protecting the rights and entitlements of Beneficiaries¹.

Trustees hold trust capital and income on trust for the Beneficiaries and generally have powers and obligations to distribute income and capital to them. In the case of most family discretionary trusts the Trustee has the right to determine which of a defined class of beneficiaries is to receive income or capital of the Trust. In most family discretionary trusts the defined beneficiaries include mum, dad and the kids and the Trustee is controlled by mum and dad.

In unit trusts the beneficiaries have a fixed entitlement to the income and capital of the Trust and hold 'units' to record their proportional entitlement. The Trustee has no discretion and must distribute income and the capital of the Trust to the Beneficiaries in the same proportion that they hold units in the trust.

The High Court of Australia has recently (March 2010) determined an appeal which involved consideration of the terms and conditions of a family discretionary trust deed and the ability of the Trustee to make determinations about the nature and distribution of trust income² (Bamford's Case).

Bamford's Case concerned a family discretionary trust and a question whether the beneficiaries were 'presently entitled to a share of the income of the trust estate' and required an enquiry as to the meaning of the word 'share' and the phrase 'the income' and 'net income' of the trust estate.

¹ Trusts Act 1973 (Queensland).

² Commissioner of Taxation v Bamford [2010] HCA 10.

Income and other taxes are assessed by the ATO in terms of the Income Tax Assessment Act 1936 (Cth) [Tax Act]. Where trusts have been created and earn income the general intent of the Tax Act is to secure payment of tax upon the whole of the 'net income of a trust estate' by either the Beneficiaries or the Trustee whether or not the income is actually paid to the Beneficiaries.

The High Court looked very closely at Section 97(1) of the Tax Act. That section provides, relevantly, that *'where a beneficiary of a trust estate ..is presently entitled to **a share of the income of the trust estate** ..the assessable income of the beneficiary shall include...so much of that share of the **net income** of the trust estate'*.

Trustees may either distribute the net income of the Trust estate to Beneficiaries or hold on to it where it is described as being 'accumulated'. If a distribution is made to a Beneficiary the Trustee does not pay tax on the income, the Beneficiary does at the Beneficiaries marginal rate of tax. On the other hand if the Trustee makes no distribution and accumulates the income it is taxed in the hands of the Trustee at the highest marginal tax rate. You may recall your taxation advisor preparing and having you sign minutes of a meeting of the Trustee of your family trust determining distributions of income to members of your family as Beneficiaries.

There is nothing controversial or difficult about the general intent and effect of Section 97(1). However like pretty well everything in life the devil is in the detail and this may have become apparent to the Bamford's after they lodged tax returns for their family trust some years ago.

If you or your trustee buy a property and you later sell it at a price greater than its cost price it may be that the difference between the cost price and the sale price has to be accounted for in the relevant tax return as a capital gain. If that is so the gain is treated as 'income' and is added to any other income you or your Trustee have derived from other sources and the taxpayer pays tax on it at the appropriate marginal rate.

In Bamfords Case there were two distinct issues determined by the High Court and they arose in different tax years.

The first was really a tax practice issue and may be resolved simply by the Trustee making distributions of income in proportions or percentages rather than in fixed amounts.

The second issue concerned the ability of a Trustee to determine whether capital gains may be treated as income of the trust for the purposes of distributions to beneficiaries. The court determined that this is possible if the terms of your trust deed permits the trustee to make determinations of that sort.

A large number of standard trust deeds have had provisions of this nature for some years.

What should you do ?

Your tax advisor or accountant will be familiar with Bamford's Case and may recommend that you undertake a review of the terms of your trust deed. You may have already received a letter of this nature.

In some instances the recommendation may be somewhat alarmist by suggesting that your trust deed may not contain an appropriate 'definition of income' and that any required change may cause a 'resettlement' with adverse tax and duties consequences. Unsolicited invitations from tax advisors offering to review your Trust Deed should be considered with caution.

You should start your enquiries off by asking your tax advisors whether you have lodged returns that might become the subject to review by the ATO in light of the Bamford decision.

Most trust deeds contain provisions that permit Trustees and others to make amendments to its terms and the powers of the Trustee.

We are able to review your Trust Deed and will advise you promptly if we consider that some change is required. If you would like us to undertake this review you should provide us with a complete copy of your trust deed and any variation to its terms since it was established.

If we consider that your trust deed requires change we will advise you how we consider that this could be achieved and will provide you with a cost estimate for undertaking that work before proceeding further.

We hope that we can be of assistance to you and if you would like to contact us. Christina Maclean would be happy to respond to your enquiry. Her contact details are christina.maclean@connollysuthers.com.au .

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