At last some clarity with the streaming of franking credits? But trust law re-write still urgently needed

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The recent case of *Thomas v FCT* [2015] FCA 968, reported at para [1424] of this *Bulletin*, considers a number of key issues relating to the distribution of franking credits by the trustee of a discretionary trust, including the ability to stream franking credits as a separate class of income.

It follows the well-publicised decision of the Queensland Supreme Court in *Thomas Nominees Pty Ltd ACN 010 049 788 v Thomas & Anor* [2010] QSC 417 (reported at 2010 WTB 49 [1884]), which relevantly held that franking credits could form part of the income of a trust estate for trust law purposes and be streamed to particular beneficiaries. The Commissioner was not a party to that earlier decision.

The *Thomas* case explores the interaction between s 95 and s 97 of the ITAA 1936 dealing with trust income and Div 207 of the ITAA 1997 dealing with the imputation system.

The decision is a timely reminder of the need to ensure that trust distributions are made in compliance with the trust deed, the ITAA 1936 and the ITAA 1997, and of the complexities that can arise when streaming different classes of income.

Facts

A more detailed summary of the facts of the case are set out at para [1424] of this *Bulletin*, however in brief, the trustee of Thomas Investment Trust purported to distribute the trust's income in several consecutive financial years as follows:

- Around 90% of the franking credits and foreign income and 1% of the remaining net income to an individual beneficiary.
- The balance of the net income to a corporate beneficiary.

The Commissioner challenged the effect of the distributions and in essence, argued that the franking credits could not be distributed to a beneficiary independently of the franked dividend to which those franking credits related.

The taxpayer contended that the franking credits were in fact a class of income capable of being streamed to particular beneficiaries in accordance with the trust instrument.

A number of other matters relating to the trust instrument and distribution resolutions were considered by the Court, which are beyond the scope of this article.

Outcome

The judgment, which the Commissioner at least is likely to believe is a thorough and well-crafted decision, rejects the earlier conclusion in *Thomas Nominees Pty Ltd ACN 010 049 788 v Thomas & Anor* [2010] QSC 417 and provides significant guidance in relation to the streaming of franked dividends and franking credits.

It is widely understood that Div 207-55(3) of the ITAA 1997 provides that a beneficiary's share of a franked distribution is equal to the amount included when determining the beneficiary's share of the trust's income under s 95 of the ITAA 1936.

Div 207 also recognises and permits a trustee to stream some or all of a franked dividend to one or more beneficiaries to the exclusion of others, subject to the requisite powers under the trust deed.

Provided the relevant trust instrument expressly permits streaming of franked dividends as a separate class of income, a trustee can choose to make one or more beneficiaries specifically entitled to franked dividends, while distributing other classes of income to different beneficiaries.

Any beneficiary who is made specifically entitled to franked dividends is then entitled to the benefit of the franking credits attaching to those dividends.

In *Thomas*, the trustee purported to stream franking credits as a separate class of income from the dividends themselves. This approach, permitted under the trust deed, saw one beneficiary receive the benefit of the tax offset under the imputation system at their marginal tax rate, while another beneficiary paid income tax on the dividend at the corporate tax rate.

The Court held that, although franking credits will generally have a clear commercial value to a beneficiary (as a result of the beneficiary's ability to claim a tax offset from the credit), a franking credit is not "income" for trust law purposes.

Specifically, although franking credits constitute statutory income for the purposes of the gross-up provisions, they are a notional, statutory creation in this regard and do not constitute "ordinary income" under trust law principles.

As a result, the operation of Div 207 makes it clear that franking credits can only "attach" to the franked dividend and cannot be streamed as a separate class of income, notwithstanding any other provision that may indicate to the contrary within the trust instrument.

The outcome of the case can perhaps be best summarised by the following quote from the judgment:

"*What cannot occur if the tax offset is to be preserved…is an allocation of the s 95 net income amongst beneficiaries on a particular basis and a distribution of the franking credits otherwise attached or stapled to the franked dividends on* ***an entirely unrelated basis****, amongst the same beneficiaries*." [Court's emphasis]

Lessons

A number of lessons can be taken from the case, including:

- As regularly highlighted in this *Bulletin*, ***it is critical to "read the deed"*** before purporting to exercise trust powers, particularly in relation to trust distributions.
- While reading the trust deed (including all valid variations) is necessary, it will ***not be sufficient by itself***. There are a myriad of related issues that need to be considered that may impact on the intended distribution, aside from whatever powers are set out in the trust instrument. Examples include renunciations and disclaimers by beneficiaries, purported changes that are not permitted under the relevant trust instrument

(see for example the article at 2015 WTB 37 [1373] in relation to amending trust deeds) and the effective narrowing (for tax purposes) of permissible beneficiaries due to the impact of family trust and interposed entity elections.

- ***The wording of the distribution minute or resolution*** will be critical for determining the consequences of the distribution. Terms like "income" and "net income" will be defined differently depending on the trust instrument (even deeds that have been sourced from the same provider) and failing to understand those distinctions can result in inadvertent adverse outcomes for the trustee and beneficiaries.
- Distribution resolutions must also be crafted ***with reference to the trust instrument***, trust law principles, the ITAA 1936 and the ITAA 1997. For example, with increasing regularity, we are seeing trust deeds that require distributions take place *before* they are otherwise needed under the ITAA.
- Trustees should act with significant care when dealing with ***"notional" amounts*** such as franking credits, to ensure the intended tax and commercial objectives are achieved.
- Trustees have a duty to ensure they are aware of their ***rights and responsibilities*** under the trust deed and the limitations under the ITAA 1936 and the ITAA 1997. A failure to discharge this duty can mean a trustee is personally liable.

Ultimately however the latest instalment in this series of cases (so far) also highlights the need for the Government to prioritise the long awaited re-write of the legislation governing the taxation of trusts in order to simplify what continues to be an unnecessarily complex area of the taxation law.