Taxpayer 2 v Commissioner 1 – the continuing story of streaming franking credits via trusts; trust tax law re-write still a priority

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The recent case of *Thomas & Anor v FCT* [2017] FCAFC 57 (reported at 2017 WTB 15 [457]), contains some particularly interesting comments in relation 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]). That decision held that franking credits could form part of the income of a trust estate for trust law purposes and be streamed to particular beneficiaries. There then followed the Commissioner's subsequent (successful) application in *Thomas v FCT* [2015] FCA 968 (reported at 2015 WTB 38 [1424]), which concluded that franking credits were not net income of the trust and therefore could not be "streamed" independently from the net income.

Facts and original decision

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.

In the original decision, the taxpayer successfully obtained a declaration from the Supreme Court of Queensland in relation to the proper construction of the trust resolutions distributing the income in the manner summarised above.

In particular, the taxpayer commenced proceedings seeking directions under s 96 of the *Trusts Act 1973* (Qld) as to the manner in which the trust deed and trust distribution resolutions should be interpreted.

The Commissioner was notified of the application but informed the taxpayer's solicitor that it did not consider it appropriate for the Commissioner to be a party to the proceedings.

The Court granted the orders requested by the taxpayer, largely on the terms requested, which included that the proper construction of the trust deed and resolutions resulted in the majority of the franking credits passing to an individual, notwithstanding that the balance of the net income went to the corporate beneficiary.

Commissioner's appeal

Following the decision above, 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 judgment issued by the Federal Court rejected the earlier conclusion of the Queensland Supreme Court and provided significant guidance in relation to the streaming of franked dividends and franking credits.

In particular, it confirmed that Div 207 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.

However, the Court held that, while 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.

Consequently, 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 Court held 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 and found in favour of the Commissioner.

Taxpayer's subsequent appeal

The taxpayer's appeal in *Thomas & Anor v FCT* [2017] FCAFC 57 essentially hinged on the nature of the original decision issued by Applegarth J in *Thomas Nominees Pty Ltd ACN 010 049 788 v Thomas & Anor* [2010] QSC 417.

The taxpayer argued that the nature of the orders issued by Applegarth J regulated the rights of the beneficiaries and the trustee and had conclusively determined each beneficiary's share of the trust's net income.

In particular, the Full Federal Court noted:

"*The application before his Honour [(ie Applegarth J)] required the Court to make sense of what may, perhaps not unfairly, be described as confused resolutions. The resolutions purported to do something and an ultimate intention could fairly be discerned however ineptly the two resolutions may have been drawn.*

However the rights of the beneficiaries flowing as against the Commissioner from Div 207 of the 1997 Act depended wholly upon the effect of the rights created as between the trustee and the beneficiary by whatever the resolutions may have achieved.

The rights to be created by the trustee as against the Commissioner were a matter wholly within the control of the trustee and it was in the jurisdiction of the Supreme Court to make declarations concerning the proper construction of what the trustee had done pursuant to a domestic trust."

The Court went on to say:

"*The Commissioner was not obliged to participate in that proceeding, and may not be bound by the construction of Div 207, but the Commissioner is bound by a declaration concerning the effect of the resolutions if the declaration conclusively determines that a beneficiary has a share of the trust's net income for a year of income that is covered by s 97(1)(a) of the 1936 Act*."

Consequently, the Court found in favour of the taxpayer for the income years in which the original orders had been granted (2005-2008) and, "reluctantly", also for the 2009 resolutions, which had not been expressly considered by Applegarth J.

Although the taxpayer was successful, the Court appeared unimpressed by the reasoning of Applegarth J in his original decision on a number of occasions.

For instance, Pagone J commented:

"*Applegarth J's declaration in 1(b)(iii) is, perhaps surprisingly, that the resolutions which the trustee had made in the years ended 30 June 2005 to 30 June 2008 had conferred upon each of the beneficiaries a vested and indefeasible interest in the distributable income consistent with the intended flow of franking credits*."

More bluntly, Pagone J said:

"*It is difficult to embrace the conclusions of Applegarth J ... The franking credit distribution resolution is explicable only by a fundamental confusion in the mind of the person drafting the resolution … Applegarth J, however, was persuaded …*"

Perram J also noted:

"*Like Pagone J, I am, with respect, sceptical about the construction of the resolutions adopted by Applegarth J, but that scepticism simply does not matter whilst the declaration remains on foot. It is what it is. That it might be attended by reasoning which may be erroneous is irrelevant whilst it exists*."

It seems clear from the decision that the taxpayer has enjoyed an extremely fortunate outcome, essentially leveraging the interplay of a number of technicalities to engineer an unlikely win.

Indeed, it can also arguably be assumed that, with the aid of hindsight, the Commissioner would be regretting his decision not to be included as a party to the original application to the Queensland Supreme Court.

Position in relation to streaming franking credits

While the case is at face value a victory for the taxpayer, it far from authority for the conclusion that franking credits can be streamed as a separate class of income from the dividends giving rise to those credits.

Indeed, in the absence of construction orders like those granted here by Applegarth J in the Queensland Supreme Court, the correct interpretation of Div 207 is that outlined by Greenwood J in *Thomas v FCT* [2015] FCA 968.

That is that while 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.

Pagone J makes this abundantly clear by stating that the trust resolutions here, and in turn Applegarth J's analysis:

"*…proceeded upon the same misunderstanding of the proper operation of Div 207; that is, upon the misunderstanding that franking credits could be distributed separately*."

Lessons

Ultimately, as explained in our previous article (see 2015 WTB 38 [1405]), there are a number of lessons that can be taken from these decisions.

Certainly, as a starting point, there is 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.

As set out previously, the other key lessons include the following:

- 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.