Tax Training Notes

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1 Family groups and family trust elections

The family trust election is used in four places in tax law:

- In the trust loss measures to simplify the tests to be passed to claim deductions, revenue losses or bad debts;
- In the company loss measures to simplify the tests to be passed to claim revenue or capital losses or bad debts;
- In the imputation credit trading measures to allow franking credits to be used by a beneficiary of a non-fixed trust; and
- In the family trust distributions tax rules to determine whether or not a trust is part of a family group.

Although used in these four places in tax law, the complexity of the law often meant that taxpayers that needed to make an election failed to make an election at the required time.

As well as elections not being properly timed, there are three other common issues connected with the making of a family trust election:

- Family Trust Distributions Tax and the definition of 'family';
- The ability to change the individual specified in an election once an election has been made; and
- The fact that a family trust election is generally irrevocable, which can lead to Family Trust Distributions Tax being payable where it otherwise would not.

Note that for the election to be made the trust must pass the family control test, requiring that members of the family group control the trust from the time that the election is to apply from until the end of the financial year in which the election is to be made. The group for these purposes consists of the test individual, their family, and in some cases legal or financial advisers to the test individual.

1.1 Timing of election

The time that an election needs to be made differs depending upon the purpose for which the election is being made. The time that an election needs to be made is set out in the table below.

Reason for election	**Time election needs to be in place**
Claiming deductions or losses against income injected	The year in which the income is injected[1]
Claiming carried forward losses	The year in which the loss is made
Claiming bad debts	The year in which the amount that became a bad debt was included in assessable income
Ensuring that a company can pass COT	From the time that the shares are owned, or from the time that the shares owned by the trust are to be treated as effectively owned by one individual

[1] Making the election in the year the test applies will change the definition of outsider for the purposes of the income injection test

	(being the trust)
Allowing a beneficiary to claim imputation credits	The year in which the franking credits are to be claimed in the beneficiary's tax return
Being part of a family group for the purposes of family trust distributions tax[2]	The year in which a benefit is provided to the trust

1.1.1 Retrospectivity in family trust elections

Following the administrative concessions offered by the ATO[3], the Government introduced a practical measure through Act No 41 of 2005, Tax Laws Amendment (2004 Measures No. 7) Act 2005, allowing retrospective family trust elections to made at any time. Importantly however, the earliest year that could be nominated in a retrospective election is the 2005 income year[4]. To be eligible to make an election that will apply from an income year earlier than that of the tax return year in which the election is made, the trust must[5]:

- From the time the election is to apply from to the end of the income year in which the election is being made the trust pass the family control test; and
- There can be no conferrals of present entitlements to income or capital or no distributions of income or capital to persons outside the family group from the time the election is to apply from.

This ability to make a retrospective election changes the way in which the family trust election needs to be viewed.

Prior to the legislated ability to make a retrospective election, it was important to identify whether an election was needed in a year in which income was earned, or a loss was made, for the purpose of deducting bad debts or deducting prior year losses. If an election was not made at the proper time, then there was no ability to "fix" the problem. In the case of elections for other purposes that were simply overlooked, there was also no ability to fix the problem. That is no longer the case as long as one is comfortable that the requirements for a retrospective election will be able to be met.

What needs to be properly understood at the time that an election may need to be made retrospectively is what it means for there to be no conferrals of present entitlements to income or capital or no distributions of income or capital to people outside the family group.

1.1.2 Conferrals and distributions

To make an election that will apply from an earlier income year, the requirements of section 272-80(4A) of Schedule 2F of ITAA1936 must be met. These provisions set out:

> "either:
>
> (i) any conferrals of present entitlement to income or capital of the trust made by the trustee during that period have been made on; or

[2] Note that prior to 1 July 2007 making a family trust election did not make a trust part of a family group, and that instead an interposed entity election was necessary

[3] As a result of consultation the ATO has offered a number of administrative concessions to allow taxpayers to make "retrospective" elections to correct the timing of making of a family trust election. The last of those concessions ended on 31 May 2007.

[4] See section 272-80(4A) of Schedule 2F of ITAA1936

[5] Section 272-80(4A) and 272-80(4) of Schedule 2F of ITAA1936

(ii) any distributions of income or capital of the trust made by the trustee during that period have been made to;

the individual specified in the election or members of that individual's family group."

In the case of conferrals of present entitlement it should be a simple matter of determining in whose favour the trustee has exercised its powers of appointment of income or capital. If the only persons to benefit from appointments of income and capital are either the specified individual or members of their family, then this part of the test will be satisfied.

What will be more difficult is determining whether a distribution of income or capital has been made to people outside the specified individual or their family group. The difficulty arises because of the way in which distribution is defined with Schedule 2F.

The term distribution is broadly defined for the purposes of Schedule 2F[6] and includes where an entity:

- pays (including by way of a loan) or credits money of the entity to the person, or reinvests such money for the person; or
- transfers property of the entity to, or allows use of property of the entity by, the person; or
- deals with money or property of the entity for or on behalf of the person or as the person directs; or
- applies money or property of the entity for the benefit of the person; or
- extinguishes, forgives, releases or waives a debt or other liability owed by the person to the entity.

The distribution is however only taken into account to the extent that the value of the distribution exceeds the amount or value of any consideration given in return.

While in a "normal" discretionary trust situation it is unlikely that a distribution would be made outside the family group intentionally, transactions such as non-interest bearing loans to unrelated parties are common as part of investment arrangements and could mean that there is no opportunity to make a retrospective election.

1.2 The narrow definition of family

A distribution by a trust that has made a family trust election in favour of a person or entity outside of the family group will be subject to family trust distribution tax. Family trust distribution tax is a tax imposed on the trustee or trustees of the trust (and directors of a corporate trustee) and is assessed at the rate of 46.5%.

The family group includes the family of the individual specified in the family trust election and certain other entities 100% owned by family members, entities that have made interposed entity elections or family trust elections specifying the same test individual[7] and certain other entities.

The original definition of family, for the purposes of family trust distribution tax, provided that the term family included, broadly:

- any parent, grandparent, brother, sister, nephew, niece, child, or child of a child, of:
    - the test individual; or

[6] Subdivision 272-B of Schedule 2F of ITAA1936
[7] For years including 24 September 2007 and later years

- the test individual's spouse;

- the spouse of the test individual or of anyone who is a member of the test individual's family above.

This definition was proposed to be changed in the 2006-07 Federal Budget so that lineal descendants would be included in the definition of family. This change was legislated in Tax Laws Amendment (2007 Measures No 4) Act 2007, with effect for income years including 24 September 2007 and later years, and included in the definition of family lineal descendents of the nieces and nephews and children of the test individual and the test individual's spouse.

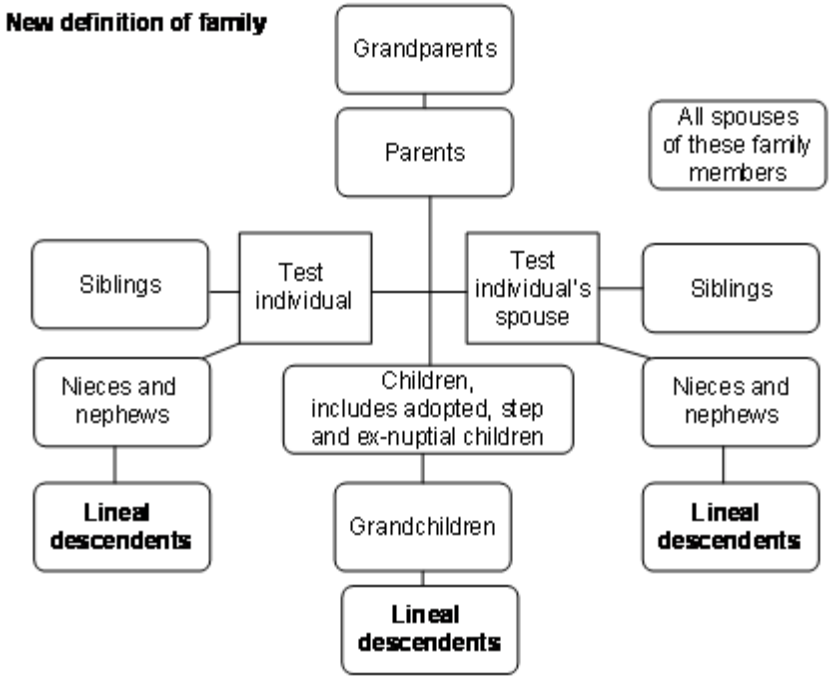
As part of the Labour party's election campaign, they announced that they would be reversing changes made by the Liberal Government as part of the Tax Laws Amendment (2007 Measures No 4) Act 2007 but it was unclear what would actually be reversed. As part of the 2007-08 Federal Budget of the Labour Government it was announced that[8]:

> "The Government will change the definition of family in the family trust election rules to limit lineal descendants to children or grandchildren of the test individual or of the test individual's spouse. This will have effect from 1 July 2008."

This was to mean that for the 2008 income year the definition of family would be effectively larger than what it had been or would be for other years.

The Labour Government failed to pass the legislation changing the definition of family group leaving the definition of family group as amended by the Liberal Government for the years including 24 September 2007 and later years.

The family group can be depicted as[9]:



As a result of the recent act, Same-Sex Relationships (Equal Treatment in Commonwealth Laws--General Law Reform) Act 2008, from 1 July 2009 the term 'spouse' will include a same sex partner. The definition found in section 995-1 of ITAA1997 is changing from that time to read:

[8] Budget Paper No. 2 , Part 1: Revenue Measures , Treasury
[9] Explanatory Memorandum to Tax Laws Amendment (2007 Measures No 4) Bill 2007 at 8.45

> **spouse** of an individual includes:
>
> (a) another individual (whether of the same sex or a different sex) with whom the individual is in a relationship that is registered under a *State law or *Territory law prescribed for the purposes of section 22B of the Acts Interpretation Act 1901 as a kind of relationship prescribed for the purposes of that section; and
>
> (b) another individual who, although not legally married to the individual, lives with the individual on a genuine domestic basis in a relationship as a couple.

Taking together the 24 September 2007 changes and the changes to apply from 1 July 2009 the definition of family would now likely mean that few if any distributions would be subject to family trust distribution tax. The notable exceptions from a family group include the aunts and uncles of the test individual, cousins and financially dependant persons that are otherwise unrelated.

1.3 Ability to change the test individual

As part of the 2006-07 Federal Budget the Liberal Government had attempted to allow some flexibility where the "wrong" test individual was chosen as part of the making of a family trust election, and changed the law to allow the test individual to be changed, once, where the new test individual is a member of the original test individual's family at the election commencement time.

The variation is not available if there has been a conferral of present entitlement to (or distributions of) income or capital of the trust (or of an entity for which an interposed entity election has been made in relation to the trust) outside the new test individual's family group during the period in which the election has been in force.

The variation of a test individual must be made for an income year that occurs before the end of the fourth income year after the income year specified in the family trust election. For family trust elections that were made prior to four income years before the start of the income year in which Tax Laws Amendment (2007 Measures No. 4) Act 2007 received Royal Assent (the 2008 income year), the trustee of the family trust has until the end of the income year following the one in which this Bill receives Royal Assent to vary the test individual (the 2009 income year).

In addition to the ability to change a test individual within four years of making the election, which can occur only once, the test individual to be changed in the case of marriage breakdown. In this case the test individual may be varied if, as a result of a family law obligation arising from a marriage breakdown, the control of the trust passes to the new test individual and/or his/her family members. Specifically, if an order, agreement or award results in the control of the trust passing to the new individual and members of the new individual's family, the test individual specified in the family trust election may be varied.

1.4 Irrevocability

The family trust election rules, up until 1 July 2007, did not allow for the revocation of a family trust election, except in one specific circumstance. The revocation could occur where the trust was a fixed trust where all of the entitlements were held by family members, and where at a time after the election was made, someone outside the family group began to hold a fixed entitlement to income or capital in the trust[10].

Since the changes introduced by Tax Laws Amendment (2007 Measures No. 4) Act 2007 it has been possible to revoke an election, effectively where that election was not necessary. A similar change was made for interposed entity elections.

[10] Section 272-80(6) of Schedule 2F of ITAA1936

An election can be revoked unless tax losses have been recouped, bad debt deductions have been claimed or franking credits have been claimed during a specified period where the recoupment or claim was only possible because of the family trust election.

The specified period begins at the start of the income year specified in the family trust election and ends on the last day of the income year immediately prior to the income year specified in the revocation.

The revocation of a family trust election must be in respect of an income year that occurs before the end of the fourth income year after the income year specified in the family trust election. For a family trust election that was made prior to four income years before 1 July 2007, the trustee of the family trust has until 30 July 2009 to revoke the family trust election.

The revocation needs to be made in the trust's tax return for the income year from which the revocation is to be effective. If the trustee is not required to lodge a tax return in that year, the revocation needs to be given to the Commissioner by the end of two months after the end of the income year specified in the revocation.

There is one very good reason for potentially revoking a family trust election or an interposed entity election, being family trust distribution tax. Where a distribution, broadly defined as noted above, is made to someone outside a family group, family trust distribution tax is payable. This tax is levied upon the trustee of the directors of a corporate trustee and is levied at 46.5%.

It has often been the case that a family trust election has been made to "simplify" the tests that might need to be passed to claim losses or bad debts without regard being had to whether the test would be passed without the making of an election. In this case if there have been no distributions outside of the family group it is worthwhile considering whether revocation of the election can occur, i.e. whether the tests would be passed without the making of the election.

In addition many people continue to make interposed entity elections to include wholly owned companies and fixed trusts in family groups where this is unnecessary given that they are included in the family group by definition. In this case the making of the election effectively makes the entity unsaleable, as well as exposing the trustee or directors to family trust distribution tax in the future. In all instances you should consider revoking interposed entity elections where the entity is already part of a family group.

2 Distributing capital gains

The ability to have capital gains assessed to a beneficiary rather than the trustee is the focus of a recently leaked ATO document[11]. It is surmised that the draft ATO practice statement will deal with the same issues as PSLA 2005/1(GA) which is concerned with whether a trustee or a beneficiary is taxable on a capital gain of a trust.

To understand why there is an issue to be dealt with in a practice statement, it is necessary to consider:

- The operation of section 97(1) to include an amount in a beneficiary's income;
- The ANZ Bank, Cajkusic and Bamford cases; and
- The ATO's current practice statement PSLA 2005/1(GA).

A problem exists in both having capital gains flow out of a trust where there is no 'income' (but see Bamford's case handed down on 3 June 2009) and where there is a desire to stream capital gains.

2.1 Section 97(1)

In determining what amount of income will be assessable in the hands of a presently entitled beneficiary you need to consider the operation of the provisions of section 97(1) of ITAA1936 for a beneficiary that is presently entitled to a share of the income of a trust.

Section 97(1) provides that:

> Subject to Division 6D, where a beneficiary of a trust estate who is not under any legal disability is presently entitled to a **share of the income of the trust estate** -
>
> (a) the assessable income of the beneficiary shall include-
>
> (i) so much of that **share of the net income** of the trust estate as is attributable to a period when the beneficiary was a resident; and
>
> (ii) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia; … (emphasis added)

2.2 Income and net income

The term "net income" in section 97(1) is a defined term in ITAA1936. The definition is found in section

95(1) which provides that net income is:

> … in relation to a trust estate, means the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions, except deductions under Schedule 2G and except also, in respect of any beneficiary who has no beneficial interest in the corpus of the trust estate, or in respect of any life tenant, the deductions allowable under Division 36 of the Income Tax Assessment Act 1997 in respect of such of the tax losses of previous years as are required to be met out of corpus.

The net income of a trust is therefore an amount determined mathematically by deducting from the trust's assessable income the amount of the allowable deductions for the trust (as modified).

The net income of a trust is not an amount to which a beneficiary is presently entitled, it is merely an amount of which a share might be included in the beneficiary's assessable income. Instead what a beneficiary may be presently entitled to is a share of the "income" of a trust.

[11] Australian Financial Review 18 May 2009 'ATO targets trusts in tax crackdown'

What constitutes the income of a trust is not defined in tax law, and we need to look to case law for assistance in understanding what is meant by "income" for the purposes of section 97(1).

2.3 Share of the income of the trust estate and share of the net income of the trust estate

If you do receive a share of the income of the trust estate, section 97(1) includes in your assessable income a share of the net income of the trust estate. The courts have concluded that a proportionate approach should be used in determining the quantum of net income to be included in the assessable income of a beneficiary[12]. Aside from the brief comment below concerning the potential problem with adopting tax law principles in determining the quantum of the income of the trust to which a beneficiary is presently entitled, it is assumed in this paper that the proportionate approach will prevail.

2.4 Trustee assessed under s99 or s99A

To the extent that a beneficiary is not presently entitled to an amount of the income of a trust the trustee is assessed on the amount under section 99A (presuming the trust estate did not result from a will or a codicil to the same).

Note that if the trust's income included a capital gain that had been reduced by the CGT general discount or the small business CGT concessions small business reduction, the benefit of those reductions is reversed when determining the amount to be assessed to the trustee under section 99A.

2.5 ANZ Bank High Court case

Since the ANZ Bank High Court case[13] there has been some doubt as to whether the trust deed definition of income is important in determining what is meant by the term "income" in section 97(1). That case has been interpreted as standing for the proposition that income means income according to ordinary concepts, i.e. it does not include gains from the sale of capital assets. The quote from that case that led to this view was:

> "The circumstance that the trust instrument, for the purpose of dealing with the entitlements of unit holders, treated the deductible amount as capital, did not alter what was described in Charles v Federal Commissioner of Taxation as "the character of those moneys in the hands of the trustees."

The facts in the case are, to me, complicated, but broadly there was an arrangement where two ANZ companies entered into a partnership and acquired units in a unit trust. The companies borrowed to acquire their units in the trust. The trustee of the unit trust in turn acquired an annuity. The return on an annuity included an amount that was a return of its purchase price and this amount was excluded from being included in assessable income by virtue of section 27H of ITAA1936[14]. If the companies had borrowed funds to acquire the annuity directly then part of the return that they received would not have been included in their assessable income, and so to that extent they would have been denied a deduction under section 51(1) of ITAA1936[15].

At issue was whether the provisions of section 97(1) would result in them being taken to include in their exempt income a portion of the income not subject to tax in the hands of the trustee, as in this instance some of their interest would not be deductible.

The trust deed of the unit trust defined income to mean the "…net income of the fund as determined in accordance with s 95 of the Act". Under the deed the deductible amount in section 27H was treated as capital and the assessable amount was treated as income.

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[12] Zeta Force Pty Limited v FC of T 98ATC 4681, Richardson v FC of T 97 ATC 5098
[13] FC of T v Australian and New Zealand Savings Bank Limited [1998] HCA 53
[14] The provision including annuities and superannuation pensions in assessable income
[15] The case related to 1986 and 1987

The High Court found that the treatment of the amount of the non-assessable amount as capital under the deed did not change the characterisation of the amount in the trustee's hands, and hence the characterisation that applied to the trustee applied to the beneficiary.

2.6 Cajkusic decision

Mr and Mrs Cajkusic and their son were the principal beneficiaries of the Cajkusic Family Trust ("the Trust").

In the 1997 year the trustee claimed a tax deduction for contributions to an employee benefit trust. The amount of the contribution was $205,425. After accounting for this contribution the trust had a loss for the year of $54,838.

In the 1998 year the trustee again claimed a tax deduction for contributions to the fund. The amount of the contribution was $197,125 resulting in a net income for the year of $28,697 (prior to deducting prior year losses from the 1997 year).

The Commissioner disallowed the deduction for the contributions, applying Part IVA to the arrangement and issuing amended assessments to the beneficiaries including the disallowed amount in their respective assessable incomes.

The beneficiaries appealed to the AAT which ruled in favour of the Commissioner regarding the disallowance of the deduction. The beneficiaries then appealed to the Full Federal Court regarding the inclusion of the disallowed amount in their individual assessable incomes. It was their contention that the amounts should be taxed to the trustee instead.

At issue was whether the disallowed deductions should be included in the assessable income of the beneficiaries or be taxed to the trustee and whether the trust deed successfully defined and re-characterised what was deemed to be income of a trust estate?

The trust deed granted the trustee power to determine what amounts were to be treated as income and what amounts were to be treated as capital, and also granted the power for the trustee to choose whether income was to be classified according to the definition of net income provided by Section 95 of ITAA1936.

The trustee had not elected for income to be determined in accordance with Section 95 and in preparing the financial accounts had treated the contributions to the employee benefit funds as a revenue deduction which created a loss for the trust.

The Commissioner submitted that the trust deed was unable to modify what is to be treated as income for trust law purposes as it would allow trustees to define their way out of the provisions of the ITAA. In response to this the Full Federal Court stated that:

> …the terms of the trust instrument will prevail over any accounting principles that may otherwise be appropriate to the type of business being conducted.

The Commissioner cited the ANZ High Court decision as supporting the proposition that you cannot define your way out of the provisions of the ITAA, but the Full Federal Court explained that the High Court was "concerned with a totally different matter".

> The point the Chief Justice was making was that it was not possible by the terms of the trust deed to bifurcate a receipt in the hands of the trustee which was income according to ordinary principles, and therefore income for the purposes of calculating the s 95 'net income', so that some part of that receipt was not income in calculating the s 95 'net income'. The Chief Justice was not, as the respondent's submission would have it, saying that a provision of the trust deed could not

> prescribe what was a receipt on revenue account and what was an outgoing on revenue account for the purpose of determining the s 97 income, that is, the distributable net income.

(By distributable net income their Honours were referring to "income" for the purposes of section 97(1))

As the Full Federal Court determined that the power granted to the trustee under the deed to define what was on income account and what was on capital account was correct, the trustee's treatment of the contributions as a revenue expense was deemed to be correct meaning that for the 1997 income year the trust had made a loss.

As there was no "income" for the trust for that year, there could be no beneficiary presently entitled and therefore any net income (taxable income) would be assessed to the trustee.

The ATO were denied special leave to appeal to the High Court against the decision of the Full Federal Court. This case therefore stands for the proposition that the trust deed will be the instrument that must be looked to in determining the quantum of income for the purposes of section 97(1).

2.7 Bamford decision

Mr and Mrs Bamford were the directors of a company which was the trustee of the Bamford Trust ("Bamford Trust"). Mr and Mr Bamford were both within the discretionary class of beneficiaries of the Bamford Trust and the Church of Scientology was also within this class.

The 2000 financial year

In May 2000, the Bamford Trust made a contribution of $175,000 to the Bamford International Super Fund on behalf of Mr and Mrs Bamford in their capacity as employees of the trust. The trustee borrowed in order to fund this contribution and incurred an interest expense on this borrowing of $16,701 in the year ending 30 June 2000.

The trustee recognised the $175,000 superannuation contribution and the $16,701.67 interest paid as expenses in its accounts for the 2000 income year. It also claimed deductions against its assessable income for these amounts.

The resolution of the trustee to distributed income in the 2000 year stated that income would be distributed as follows:

- J H Bamford (the first $643);
- H J Bamford (the next $643);
- Narconon Anzo Inc (the next $12,500);
- Church of Scientology (the next $106,000);
- **P J & D L Bamford (the next $68,000 shared equally); and**
- Church of Scientology (the balance).

In its 2000 income tax return, the Bamford Trust made the following distributions of taxable income to its beneficiaries:

- J H Bamford ($643);
- H J Bamford ($643);
- Narconon Anzo Inc ($12,500);
- Church of Scientology ($106,000);
- **P J Bamford ($33,872); and**
- **D L Bamford ($33,872).**

Note that on these numbers Mr and Mrs Bamford each received 18.062% of the trust's initial taxable distributions and that the provision stating that the Church of Scientology would take the balance of any distribution had no effect as all of the income had been dealt with by the preceding dot points.

In 2005 the ATO disallowed the deductions for the superannuation contributions and interest under Part IVA.

Amended assessments were issued Mr and Mrs Bamford for the 2000 income year which included an additional amount of $34,624 in their assessable incomes (18.062% of the disallowed deductions).

The 2002 financial year

The Commissioner also disallowed deductions for the trust in the 2002 income year. These were amounts of carried forward losses from the superannuation contribution and the related interest amounts. In the 2002 financial year the trust had made a capital gain that was reduced by the CGT general discount. The trustee's resolution for this year stated that income would be distributed as follows:

- P J & D L Bamford (the first $60,000 including any capital gain, shared equally); and
- Church of Scientology (the balance).

Without this capital gain, the trust did not have any accounting income for the year. Because of this, when he disallowed deductions to the trust, the Commissioner issued an amended assessment to the trustee on the basis that no beneficiary was presently entitled to the trust's income for that year. The Commissioner's view was that if there was no income according to ordinary concepts then no beneficiary could be entitled to a share of the net income (taxable income) of the trust.

Issues

Were the Bamfords assessable on the increase in taxable income in the 2000 financial year, or was the Church of Scientology more properly assessable?

Should the capital gain in the 2002 financial year be assessed to the Bamfords or to the trustee of the trust?

Decision in the AAT

The 2000 financial year

Considering the ruling in *Zeta Force*[16] (concerning the proportionate approach), the Tribunal held that the Commissioner was correct in assessing Mr and Mrs Bamford on their proportionate share of the increased taxable income of the trust. The Tribunal further stated that the proportional approach was appropriate regardless of whether the trustee appointed to Mr and Mrs Bamford a dollar amount or a percentage of the trust's income.

The 2002 financial year

The trust deed did not define 'income'. Accordingly, when the matter went before the AAT the Tribunal was of the opinion that in interpreting the income tax legislation, 'income' of the trust was properly taken to mean income according to ordinary concepts. However, the trust deed did have a clause that allowed the trustee to determine whether any amount received or paid by the trust was to be treated on revenue or capital account. Where no such determination was made by the trustee by the end of an

[16] *Zeta Force Pty Ltd v Commissioner of Taxation* (1998) 84 FCR 70

income year, this clause required that the income of the trust was to be calculated in the same manner as the net income of the trust is required to be calculated under the income tax legislation.

For the 2002 year, the Tribunal referred to the decision of the Full Federal Court in *Cajkusic v Commissioner of Taxation* [2006] FCAFC 164; (2006) 155 FCR 430 in determining who would be taxable on the taxable income of the trust in a year in which the trust did not have any accounting income:

> …if there is no s 97 income – no distributable net income – to which any beneficiary is presently entitled, then liability for the tax on any s 95 "net income" will fall on the trustee under s 99 or s 99A of the 1936 Act.

The Tribunal noted that in preparing the 2002 financial statements, the trust's accountant recorded the profit on sale of a property as revenue. This 'profit' from the sale was then recorded as a distribution to the trust's beneficiaries and allocated to their loan accounts. Despite this, it was not clear whether the trustee had made a determination, in accordance with the trust deed, whether these amounts would be treated as income or capital in the hands of the trust. The trust's accountant had argued that the fact that the trustee's distribution resolution referred to an amount 'including any capital gain' confirmed that the trustee had categorised the capital gain as income.

Despite the fact that the Tribunal accepted the accountant's argument that a determination had been made to treat the capital gain as income, the Tribunal was of the opinion that this did not mean that the amount would be 'income' for the purposes of the income tax legislation. This was because, as the trust deed did not define income, it was taken to mean income according to ordinary concepts. The fact that the trustee had the power to later re-characterise the amount as income did not alter this.

As there was no income of the trust estate in that year, the Commissioner was correct in raising an assessment to the trustee in respect of the taxable income (including capital gain) for the 2002 income year.

It is noteworthy that when the trust's accountant presented Practice Statement PS LA 2005/1 (GA), which outlines the Commissioner's concessionary treatment allowing a capital beneficiary to pay tax on a capital gain when a trust has no income for a year the Tribunal raised doubts as to whether the Practice Statement was correct at law and, in any case, the statement was not binding on the Commissioner.

Decision of the Full Federal Court

The 2000 financial year

The Full Federal Court (Emmett, Stone and Perram JJ) agreed with the Tribunal member's decision in respect of the 2000 financial year. Despite arguments put forward for the Bamfords that the provisions in section 97(1) should be interpreted differently depending upon whether the distribution minute recorded percentage or dollar amounts, it was found that a proportionate method was to be applied. If a person is entitled to a share of the income of the trust (a percentage determined based on their entitlement), then they will share in the same amount of the net income of a trust (the same percentage of the taxable income).

Emmett J noted that 'If the drafter of s 97 had intended that a beneficiary be assessed on no more than the amount of the distributable income to which that beneficiary is presently entitled, that could have been made explicit by using the word "amount" instead of the word "share" in s 97(1)'.

The 2002 financial year

All three judges, albeit for slightly different reasons, found against the Commissioner in respect of the 2002 financial year.

While the Commissioner had argued that if there was no income according to ordinary concepts then there could be no beneficiary presently entitled, the Court accepted that the provision in the deed of the Bamford Trust allowing the trustee to determine the character of a receipt operated to allow the trustee to treat the profit on sale as income.

In his judgement, Emmett J stated:

> ... it is consistent with the scheme of Division 6 that the beneficiaries who are presently entitled to share in amounts, by the operation of the terms of the relevant trust instrument, should bear the tax on those amounts. Thus, if the trust instrument prescribes that a gain that would be included in the net income of the trust estate under s 95 is also to be included in the amount of "income" to be shared by particular beneficiaries, it is consistent with the object and purposes of Division 6 to regard that amount as one to which those beneficiaries are presently entitled for the purpose of s 97. Indeed, it may be inconsistent with the legislative intention to treat it otherwise.

The judgement of Stone and Perram JJ went further than that of Emmett J in rejecting the Commissioner's public views on why the income of the Bamford Trust should have been assessed to the trustee in the 2002 financial year. The Commissioner had asserted that the decision in *Commissioner of Taxation v Montgomery* [1999] HCA 34 supported his view that 'income' meant income according to ordinary concepts (that case dealt with a lease incentive). Their honours pointed out that what was at issue in the present case was not what was meant by 'income' but instead what was meant by 'the income of the trust estate'. The Commissioner's argument (in part) and their honours response is set out below:

> The Commissioner argued that the terms of the trust deed could not determine whether an outgoing could be so treated for the purposes of determining the income of the trust under s 97. Kiefel, Sundberg and Edmonds JJ said this (155 FCR 430 at 436 [21]):
>
> > The respondent submitted that "what [is] income for trust law purposes, s 97 purposes, cannot be governed by what is said in the trust deed". That, so the submission went, "would be remarkable. You could just define your way out of what the Income Tax Assessment Act provides". Reliance for this submission was placed on three cases: Australian and New Zealand Savings Bank Ltd [1998] HCA 53; 194 CLR 328 at [15] per Gleeson CJ; Thornley v Boyd [1925] HCA 41; (1925) 36 CLR 526 at 536 per Knox CJ; and McBride v Hudson [1962] HCA 5; (1962) 107 CLR 604 at 623-624 per Taylor J. The submission is flawed for a number of reasons.
>
> The Commissioner submitted that this determination was an obiter dictum. We do not agree. The question before the Court was whether a determination by the trustee to appoint an outgoing to the revenue account could reflect the income of the trust for s 97 purposes. The Court concluded it could, in consequence of which it determined there was no income of the trust for s 97(1) purposes in the relevant year and, hence, no beneficiaries who were presently entitled. The effect of that conclusion was that s 97 did not operate to attribute any income to the taxpayers. The conclusion at [21], therefore, forms part of the ratio decidendi of the decision.
>
> The Commissioner invited us not to follow Cajkusic. We could only do so if we were of the view that it was clearly wrong. We are not of that view.

Finally their honours addressed the Commissioner's long held view on the ANZ Bank High Court Case where the High Court found that the provisions in a trust deed could not affect the character of amounts in the hands of a trustee. Stone and Perram JJ reiterated what had been said by the Full Federal Court in Cajkusic's case, being that the High Court in that case was concerned with what was *net income* and not what was *income of the trust estate.*

The final comments of the Court were:

> For completeness it should be noted that this interpretation of s 97 does not, as the Commissioner's submissions at times appeared to assume, have the consequence of thwarting the operation of the Act. Tax is exigible on the net income of the trust. If there are beneficiaries who are presently entitled pursuant to s 97, then s 97 operates to bring the entitlement of those beneficiaries in the relevant share of the net income of the trust to tax; to the extent that there are no eligible beneficiaries, the obligation to pay tax falls upon the trustee under ss 99 or 99A. The only purpose of the concept of "income of the trust estate" in s 97(1) is to determine the extent of the apportionment as between the beneficiaries and the trustee. It is not, in itself, a metric by which tax is imposed.

2.8 Potential problem with adopting tax law principles

The point has been made to me in the past that the adoption of tax law principles in determining the net income of a trust can lead to the trustee being assessed on an amount under section 99A of ITAA1936.

This could occur if the adoption of tax law principles was ineffective, and the accounting income was greater than the tax law income.

The argument would be that in adopting tax law principles, the trustee's ability to deal with the income would be fettered so that they could only distribute the tax law amount, while still having an amount of "income" for section 97(1) purposes equal to the accounting amount. The amount that the trustee was not empowered to deal with could be assessed to the trustee under section 99A.

The finding in Bamford that the deed can adopt tax law principles, it is hoped, will render this argument invalid, although caution will need to be exercised until it is known whether the Commissioner will seek special leave to appeal to the High Court.

2.9 Streaming capital gains

One of the attractive features of a non-fixed or discretionary trust is the ability to stream distributions of income and capital to beneficiaries in the most effective manner on a year by year basis.

Particularly, there is a benefit in being able to stream capital gains to beneficiaries with capital losses, or to beneficiaries who may benefit from the CGT general discount.

The ability to stream distributions is dependant on the following:

- The terms of the trust deed;
- The resolutions made by the trustee;
- The way that capital gains are included in assessable income; and
- The case law as it stands at a particular point in time.

The deed will generally need to empower the trustee to be able to distinguish between classes of income that represent income from such things as rents, interest, dividends, etc. and amounts that represent capital gains. The deed would also need to empower the trustee in appointing income to a beneficiary to decide what class of income or what amount of a class of income will be appointed to a beneficiary.

Having the necessary power under the deed, the trustee's decision as to how to appoint income for the financial year would then need to be documented consistently with the trustee's power under the deed and their desire, for example, to appoint income to one beneficiary and capital to another.

2.10 Does deed adopt tax law or accounting concepts of income?

The ability to stream the income will differ depending upon whether the trust deed adopts tax law or accounting principles in determining what is included in the income of the trust.

Where the trust deed adopts tax law principles streaming will be a matter of correctly identifying the streaming clause and drafting the appropriate resolution.

In the case where the deed adopts accounting principles it will be important to have regard to the Commissioner's Practice Statement PS LA 2005/1 (GA) and to whether or not the trustee has the power to include amounts of capital in income.

2.11 Streaming capital gains after Bamford's case

If it was to be the correct view of the ANZ Bank High Court case that income only meant income according to ordinary concepts, and that capital gains were therefore not income, then it would be the case that a trustee would be unable to stream capital gains to a beneficiary.

This is because the recipient of the income of the trust for section 97(1) purposes would need to include all of the net income of the trust in their assessable income.

Example (if ANZ Bank case can be interpreted as governing what is income)
A trust has income of $50 from rents and a capital gain of $100. The "income" of the trust for the purposes of section 97(1)(a) in this instance would be $50. The trustee could distribute the $50 to a beneficiary and they would need to include an amount in their assessable income (assuming they are made presently entitled). As the beneficiary received a distribution of all of the trust income, they would need to include all of the net income of the trust in their assessable income, being $150. This is regardless of whether or not they became entitled to the $100 capital gain.

As noted above following the Full Federal Court decision in Bamford it appears that the deed can give the trustee the ability to include a capital gain in income. The case does not however deal with whether capital gains as a class of income can be streamed. The decision may also be appealed to the High Court by the Commissioner.

This view of an inability to stream will still be correct for deeds under which capital gains are not stamped with the character of income.

2.12 ATO Practice Statement PS LA 2005/1 (GA)

The ATO have recognised that the inability to take out capital gains to a beneficiary who becomes presently entitled to the amount of capital could lead to an unfair taxation position and issued a non-binding but very generous Practice Statement PS LA 2005/1 (GA) dealing with this issue.

In the practice statement the ATO acknowledge that where income of a trust is distributed to one beneficiary and capital gains are distributed to another beneficiary or are retained by the trustee, the income beneficiary may pay tax on funds they will never receive.

Example (different income and capital beneficiaries)
Bill and Bob are potential beneficiaries of the Billy Bob Family Trust. The trust has made a capital gain of $1,000,000 for the year and has received unfranked dividend income of $500,000. The trustee decides to distribute the $1,000,000 capital gain to Bill and the dividend income of $500,000 to Bob. If the trust deed does not define income to include the capital gain then Bob, having received all of the income of the trust will need to pay tax on the whole $1,500,000 in trust taxable income.

Example (income retained)
The trustee in the above example instead of distributing the capital gain of $1,000,000 to Bill decides to retain the amount within the trust. In this instance Bob would still be taxable on the whole trust taxable income of $1,500,000.

The ATO set out in their practice statement that in the above two cases they would accept the tax on the capital gain being paid by the trustee (the trustee approach) or by the capital beneficiary who became presently entitled to the capital gain (the capital beneficiary approach). They would also accept tax being paid by the income beneficiary.

2.12.1 Trustee approach requirements

In order to apply the trustee approach the ATO require that there be a written agreement entered into within two months following the end of the income year to the effect that the trustee will pay tax on the capital gain. The agreement needs to be entered into between the trustee, the income beneficiaries, and, if the capital gain has been appointed to a capital beneficiary within two months after the end of the income year, the capital beneficiary.

2.12.2 Capital beneficiary approach requirements

In order to apply the capital beneficiary approach a capital beneficiary must have been granted a "vested and indefeasible interest" in the trust capital representing the capital gain at the end of the income year or have been "allocated the capital gain" no later than two months after the end of the income year.

The ATO again requires a written agreement be entered into within two months after the end of the income year. In this instance however the agreement need only be between the trustee and the capital beneficiary.

2.12.3 Other cases

In the case where there is no beneficiary presently entitled to the income the ATO will of course accept that the capital gain can be assessed to the trustee under section 99A.

When there is no beneficiary presently entitled to the income, but there is a beneficiary who has been granted a "vested and indefeasible interest" in the trust capital representing the capital gain at the end of the income year or has been "allocated the capital gain" no later than two months after the end of the income year the ATO will accept that the capital beneficiary can include the amount in their assessable income. In this instance the ATO again require a written agreement to be entered into between the trustee and the capital beneficiary within two months after the end of the income year.

2.12.4 Problems

There are some problems with the practice statement in that it is not administratively binding on the ATO, as it is not a ruling or a determination, and is also incorrect at law (for instance see the comment of the Tribunal in Bamford and the finding of the Full Federal Court in Bamford).

Consideration should still be given to following the terms of the practice statement where it is intended that capital gains will be streamed.

While it is noted in the practice statement that "It must be followed by Tax officers unless doing so creates unintended consequences", it does not state for whom the consequences are unintended, the ATO or the taxpayer.

3 CGT anomalies

3.1 CGT event E4 and property trusts

In the case of the establishment of a unit trust[17] that will have the ability to derive "tax deferred" funds, it is important to consider the operation of CGT event E4. Tax deferred funds are commonly derived where income earned by a fixed trust is sheltered from taxation by the operation of the depreciation (Division 40 of ITAA1997) or capital works deduction (Division 43 of ITAA1997) provisions.

CGT event E4[18] happens if:

(a) the trustee of a trust makes a payment to you in respect of your unit or your interest in the trust (except for * CGT event A1, C2, E1, E2, E6 or E7 happening in relation to it); and

(b) some or all of the payment (the non-assessable part) is not included in your assessable income.

When this CGT event occurs you make a capital gain if the non-assessable amount you receive from the trustee is greater than your cost base. If the amount does not exceed your cost base the amount reduces your cost base.

CGT event E4 can cause effective double taxation when the amount of the cost base of the units can be reduced to zero over the life of a unit-holders holding period so that tax-deferred distributions cause capital gains. Note that the double taxation only arises if the unit-holder, in addition to paying tax on capital gains triggered by CGT event E4 is also a unit holder when the underlying property held by the trustee is sold.

Unit trusts are commonly used where more than one party is interested in acquiring an interest in real property. Reasons for choosing unit trusts as joint investment vehicles include that:

- On the sale of the unit trust's property that results in a capital gain, the unit trust can access the CGT general discount;
- The use of a corporate trustee of the unit trust can provide for a level of asset protection should the trustee be sued;
- Regardless of changes in unit holdings it is only the name of the trustee that is recognised on the property title, making for easier administration in the case of changes in underlying ownership; and
- The transfer of units is usually less costly in terms of duty, unless the transfer of units is subject to the land rich entity provisions.

Although some amounts are able to be paid by a trustee to the unit holders without triggering CGT event E4 (e.g. amounts sheltered from tax by the general discount) amounts sheltered from taxation by depreciation or capital works deductions are not include in these exceptions.

Example
A unit trust rents out property for $100,000 per annum. The expenses of the trust include operating costs of $20,000, a depreciation claim of $10,000 and a capital works deduction of $5,000.

The trust will have taxable income of $65,000 whilst having cash available for distribution of $80,000.

[17] These concepts apply to fixed trusts and not only fixed trusts that are unit trusts
[18] Section 104-70 of ITAA1997

When the $15,000 is paid to the unit holders it will be an amount that is not included in their assessable income and so will trigger CGT event E4.

To understand how double taxation may arise for a unit trust acquiring property it is also necessary to consider how the cost base of a CGT asset owned by a unit trust is affected by capital works deduction claims. For assets acquired after 7.30pm ACT time on 13 May 1997, amounts claimed under the capital works deductions provisions are excluded from the cost base and reduced cost base of a CGT asset. Thus, if the sale price of a CGT asset exceeds the cost base (which has been reduced by the capital works deduction claimed) a capital gain will arise.

3.1.1 Potential double taxation

Double taxation may occur if the payment of monies sheltered by the capital works deductions provisions triggers a capital gain for the unit holders. This is because the capital works deduction that triggers a gain for them under CGT event E4 will also likely cause an increase in the capital gain to be realised when the trust's property is sold.

Example
A unit trust is established to acquire a property for $1 million. The building on the property was constructed for $600,000 and its use will entitle the owner to a capital works deduction at 2.5% per annum being $15,000 per annum.

The unit trust is established with $1,000 of unit holder funds. The trustee borrows the remaining $999,000 from a financier.

In the first year of operation the trust has a positive net cash flow of $25,070 and taxable income of $10,070 as set out below.

Cash flow:

Rent	***$100,000***
Less interest and other costs	***($74,930)***
Net cash flow	***$25,070***

Taxable income:

Rent	***$100,000***
Less interest and other costs	***($74,930)***
Less capital works deduction	***($15,000)***
Taxable income	***$10,070***

The entire amount of the $25,070 cash available is paid to the unit holders so that CGT event E4 is triggered for the amount sheltered by the capital works deduction.

CGT event E4 causes a capital gain of $14,000, calculated as:

Amount not subject to tax for unit holders	***$15,000***
Less cost base of units	***($1,000)***

Capital gain $14,000

As CGT event E4 has triggered a capital gain the cost base and reduced cost base of the units is reduced to $nil[19].

On the first day of the next year the property is sold for $1 million. For the trust this triggers a taxable capital gain of $15,000, calculated as:

Capital proceeds		***$1,000,000***
Less cost base of building		
Initial cost	***$1,000,000***	
Less Division 43 claim	***($15,000)***	***($985,000)***
Capital gain		***$15,000***

This capital gain will be included in the unit holders' assessable income.

The trustee then discharges the debt owing of $999,000 and is left with $1,000. This amount when paid to the unit holders will trigger either CGT event C2 (if the units are cancelled) or CGT event E4 (if they are not). As the unit holders have no cost base in their units this will result in a $1,000 capital gain. The unit holders should be able to take advantage of the anti-overlap rules in subsection 118-20 of ITAA1997 to reduce the capital gain by the $1,000 as $15,000 has been included in their assessable income under subsection 97(1) of ITAA1936 (which may be seen to include the $1,000).

Thus, the capital gain recognised in the unit holders' hands of $14,000 under CGT event E4 is duplicated in the unit trust when the property is disposed of and a capital gain of $15,000 is made under CGT event A1 (which the beneficiary is then taxed on under subsection 97(1)).

This situation can be contrasted with the position where there is sufficient cost base in the units to ensure that CGT event E4 does not apply to the amount paid to the unit holders. In this case at the time the property is sold, and a capital gain is crystallised, the amount that represents the capital gain will be excluded from the capital gain under CGT event C2 as it has already been included in the beneficiary's assessable income[20].

Example
The facts are as set out above (with the same expenses for ease of comparison), but the unit holders subscribe $15,000 for their initial units and the amount borrowed is $985,000.

As the unit holders have a $15,000 cost base for their units when they receive the tax-deferred distribution they will not have a capital gain as a result of CGT event E4 at this time. Their cost base will still however be reduced to $nil.

When the unit trust sells the property it will still crystallise a capital gain of $15,000 in the unit trust. The beneficiaries will need to include this capital gain in their assessable income.

When the $15,000 remaining from the disposal of the property is paid to the unit holders it will still trigger CGT event C2 or CGT event E4, resulting in a capital gain of $15,000. As this amount has

[19] ss104-70(5) of ITAA1997
[20] It will be included in your assessable income by subsection 97(1) of ITAA1936 and be excluded from resulting in a capital gain as a result of s118-20 of ITAA1997.

already been included in the unit holders' assessable income as a result of subsection 97(1) of ITAA1936 they are able to disregard all of the capital gain.

It is also the case that if the trust property is sold before the distribution of tax-sheltered monies extinguishes the cost base of the units, this problem does not arise.

3.1.2 Two potential solutions

There are two solutions available to ensure that the above issue does not arise for a unit trust:

- Undertake any borrowings at the unit holder level; and
- Borrow from the trust in order to acquire the units.

Both solutions do however present other problems.

3.1.2.1 Borrowing at unit holder level

In this instance the unit holders would borrow in order to subscribe for units so that it would never be the case that the return of depreciation or Division 43 sheltered monies would trigger a taxable gain as a result of CGT event E4.

The only difficulty in applying this approach appears to be practical in nature. The unit holders will be borrowing, but the finance is likely to be secured against the property of the unit trust. In the writer's personal experience some financiers are uncomfortable about lending to a unit holder in this situation, with the argument often being presented that if the unit holder defaulted that the financier considers that they may have difficulty enforcing a mortgage against the trustee.

Undertaking the transaction in this manner may also allow the unit holder borrower to deduct any loss from financing costs against other income they earn.

3.1.2.2 Borrowing from trust to acquire units

Another method that results in the unit holders having a cost base large enough to ensure that capital gains tax does not become payable at the unit holder level through the operation of CGT event E4 is for the unit holders to borrow from the trust in order to acquire their units. You should ensure that the trust deed allows for this to occur.

In this instance the unit holders subscribe for units equal in value to the property to be acquired. They may pay part of the subscription price in cash, with the remaining amount owing to the trust. The trust then borrows the remaining amount necessary to secure the purchase of the property. As the unit holders in this instance will have a cost base equal to the value of the property to be acquired, they will not have to be concerned with CGT event E4 triggering a capital gain at the unit holder level as a result of tax deferred distributions received.

The unit holders would be relying on the amount they are required to pay to the trustee of the unit trust forming part of their cost base as a result of the inclusion in element 1 of the units cost base of amounts you "… are required to pay"[21]. It is clear that this amount can be included in your cost base even though it does not have to be paid until a later time[22]. In this case the balance of the subscription funds would be "paid" by the unit holders when the property is eventually sold.

[21] Subsection 110-25(2)(a) of ITAA1997
[22] Section 103-15 of ITAA1997

Example
Unit holders subscribe for 1 million units at $1 each. $100,000 is paid in cash, with the remaining $900,000 being shown as an amount owing by the unit holders to the trust. The trust then borrows $900,000 from a financier and acquires a property for $1 million.

The property is rented for $100,000 per annum, and interest of $90,000 is paid each year, and the Division 43 claim is $10,000 per annum. This results in the trust having $10,000 of cash each year, but no taxable income.

The trustee distributes the $10,000 each year and this triggers CGT event E4 for the unit holders. In year 11, their cost base is reduced to $890,000 and it is clear that without the benefit of the increased cost base that is attributable to the loan, that CGT event E4 would have triggered a taxable capital gain of $10,000. In this year it will be important that it can be argued that the $900,000 shown as a loan to the unit holders is an amount they are required to pay.

The property is sold in year 11 for $1 million so that there is no accounting gain. There is however a taxable gain of $110,000 (before the CGT general discount) due to the reduction in cost base that is attributable to Division 43. At this time the balance sheet of the trust would disclose:

Assets	***$***	***Trust capital***	***$***
Cash on hand	***100,000***	***Issued units***	***1,000,000***
Loans to unit holders	***900,000***		
	1,000,000		***1,000,000***

When the trust is vested the trustee will have an obligation to pass to the unit holders the trust property. The setting off of the unit holders' right to receive the trust property against the obligation they have to pay the $900,000 would constitute payment of the amount they promised to pay for the units.

3.2 CGT events E4 and C2

The potential for unfair taxation treatment also exists in connection with the distribution of gains from a unit trust that have been sheltered from taxation by the CGT general discount. This can occur when the trustee passes property in-specie to a unit holder rather than selling the asset and then distributing the funds to a unit holder.

It is clear that where the trustee of a unit trust makes a capital gain that is reduced by the CGT general discount and this amount is then on-paid to unit holders, that the exception in section 104-71(4) item 1 will ensure that the amount does not trigger CGT event E4.

When the general discount sheltered amount is passed to the unit holder at the same time as their unit ends, for instance when the trust is vested, then the relevant event will be CGT event C2 and not CGT event E4. There is no exception in CGT event C2 for an amount that has been sheltered from tax in the unit trust through the operation of the CGT general discount.

Example
A natural person beneficiary subscribes for 10 units at $1 each in a unit trust. The trustee uses those funds to acquire an asset. The asset is a CGT asset, it is held for more than 12 months and is now worth $110.

3.2.1 CGT event E4

The trustee disposes of the property to a third party and distributes the proceeds, in the process vesting the trust. The beneficiary's tax position will be as follows:

- The taxable gain distributed to the beneficiary will be $50.
- The non-taxable gain will be subject to the E4 exclusion and so $50 will be received tax-free.
- The vesting of the trust will cause CGT event C2 to occur, the $10 received from the trustee will be compared to the cost base of $10 so that no capital gain or loss is realised.

In summary the beneficiary will have a taxable gain of $50.

3.2.2 CGT event C2

Instead of disposing of the property to a third party, the trustee vests the trust so that the asset is transferred to the beneficiary. The trustee will realise a capital gain of $50. The beneficiary's tax position will be as follows:

- The taxable gain distributed to the beneficiary will be $50.
- The vesting of the trust will cause CGT event C2 to occur, the $60 received from the trustee will be compared to the cost base of $10 so that a capital gain of $50 is realised. This capital gain may be reduced by the general discount by the beneficiary so that they are taxable on $25.

In summary the beneficiary will have a taxable capital gain of $75.

To maintain parity between the two positions the operation of the anti-overlap provision, section 118-20 of ITAA1997 needs to be considered. This provision applies, broadly, to reduce a capital gain where a provision outside of the CGT provisions includes an amount in your assessable income. The capital gain that would otherwise be made is then reduced by the amount that would otherwise be included in your assessable income.

The above analysis of CGT event C2 has been simplified, with the fuller calculation being set out below:

Capital proceeds for cancellation of units	**$110**
Less cost base	($10)
Gross capital gain	$100
Less amount included in assessable income by section 97 of ITAA1936 (118-20 of ITAA1997)	($50)
Reduced capital gain	$50
Less CGT general discount	($25)
Taxable capital gain	$25

The application of section 118-20 of ITAA1997 to the capital gain prior to the discount applying leads to the inconsistency between CGT event C2 and CGT event E4. If however the section could be applied to the capital gain after the general discount has applied, there would be parity between the two CGT events:

Capital proceeds for cancellation of units	**$110**
Less cost base	($10)
Gross capital gain	$100
Less CGT general discount	($50)
Reduced capital gain	$50
Less amount included in assessable income by section 97 of ITAA1936 (118-20 of ITAA1997)	($50)
Taxable capital gain	$0

While it would be hoped that section 118-20 would be applied in this manner so that the two CGT events treat the CGT general discount amount in the same way a potential practical solution would be to sell the assets to the beneficiaries, distribute (pay) the amount of the gain to the beneficiaries (that includes the discount amount) and then to vest the trust. This would ensure that CGT event E4 occurs just before CGT event C2.

4 Trust cloning and the alternative – splitting

The practice of splitting or cloning trusts is usually done for asset protection purposes or to pass control of parts of a trust's property to succeeding generations.

4.1 Cloning v splitting

Cloning a trust refers to the practice of establishing another trust that is almost identical to the first, and vesting part of the assets of the first trust to the second trust. Following the Government's announcement that trust cloning would be abolished from 31 October 2008 and their budget announcement that trust cloning would be available for certain fixed trusts, the importance of cloning has diminished. In respect of fixed trust cloning it will be important to see the legislation to give effect to the budget announcement before undertaking planning or providing advice.

Splitting a trust, by comparison, does not involve the creation of a new trust, but the appointment of a new trustee in respect of some of the trust's assets. In splitting a trust there is often the need to amend the trust deed and in so doing regard needs to be had to whether the changes will result in the creation of a new trust, otherwise known as a resettlement. If a deed needs to be amended you should consider the ATO's "Creation of a New Trust – Statement of Principles"[23] that was issued in August 2001.

Often there is a difference in the duty that will apply if a trust is split as compared to cloned. Assuming that a splitting does not result in the creation of a new trust a split should be able to be stamped with nominal duty in NSW. This would require that the provisions of section 54(3) of the *Duties Act 1997* (NSW) to be met:

> Duty of $10 is chargeable in respect of a transfer of dutiable property to a person other than a special trustee as a consequence of the retirement of a trustee or the appointment of a new trustee, if the Chief Commissioner is satisfied that, as the case may be:
>
> (a) none of the continuing trustees remaining after the retirement of a trustee is or can become a beneficiary under the trust; and
>
> (b) none of the trustees of the trust after the appointment of a new trustee is or can become a beneficiary under the trust; and
>
> (c) the transfer is not a part of a scheme for conferring an interest in relation to the trust property, on a new trustee or any other person, whether as a beneficiary or otherwise, to the detriment of the beneficial interest or potential beneficial interest of any person.
>
> If the Chief Commissioner is not so satisfied, the transfer is chargeable with the same duty as a transfer to a beneficiary under and in conformity with the trusts subject to which the property is held, unless subsection 3A applies.

4.2 Why would you do it?

As noted above, trusts are normally split or cloned for two reasons. While it may occur that a trust is split or cloned for a taxation or commercial reason, asset protection and family succession planning appear to be the dominant reasons behind splitting and cloning.

In the case of asset protection it may be the case that a trust carries on a business and owns passive or investment assets. As the risk profiles of the business and the passive assets differ it would often be preferable for them to be held in separate trusts. In this instance it would be most common to clone the original trust and to vest the assets to the new trust. This is because achieving asset protection in the case of trust splitting is perceived to be more difficult than on a cloning. Regard needs to be had

[23] http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/14283.htm

however to the potential stamp duty differences and now CGT differences between a splitting and a cloning.

For family succession planning purposes it may be desirable to give control of part of a trust's assets to one part of the family, while control over the remainder is given to other family members. For instance, a trust may have two assets being real property and a share portfolio and the trust's controllers have two children, a son and a daughter. Through splitting or cloning control over the real property may be given to the son while control over the share portfolio may be given to the daughter.

4.3 CGT issues

On cloning a discretionary trust there are a number of CGT events that have potential application, being A1, E1, E2 and E5. CGT event A1 is the general event that applies to the disposal of a CGT asset, whereas the "E" events are those applying to transactions where there is a trust involved. Under the CGT provisions where more than one CGT event has potential application to a transaction it is the more specific one that applies[24]. In relation to splitting and cloning those are the "E" events.

It is noteworthy that it is still the case that CGT event A1 does not occur on the mere change of trustee despite the removal of the exception that previously facilitated cloning.

CGT event E1 occurs when a trust is created over an asset by declaration or settlement. You make a capital gain if the proceeds, generally the market value as a result of the market value substitution rules, exceeds the asset's cost base. CGT event E1 is relevant where as a result of a trust split a new trust is created, or where the vesting of an asset on cloning creates the new trust. Up until 31 October 2008 there was an exception to CGT event E1 where:

> "… the trust is created by transferring the asset from another trust, and the beneficiaries and terms of both trusts are the same."[25]

What will be of concern in splitting a trust is whether or not the mechanical requirements in setting the trust up to be split and run as a split trust will cause a resettlement. A resettlement will trigger CGT event E1. In order to set the trust up to be split it may be necessary to vary the deed to allow for separate trustees in respect of separate assets. This in itself is unlikely to cause a resettlement however the transfer of the assets to the new trustee to be held on the terms of the existing trust may be seen by some as a resettlement. For views on whether the transfer of assets would result in a resettlement the reader is referred to Mr Ken Schurgott's paper delivered at the Taxation Institute's National Convention in 2008 entitled 'Cloning or Splitting Discretionary Trusts'. It may also be preferable for their to be a new appointor in respect of the two or more parts of the split trust, and if the deed is amended to provide for separate appointors, this is another factor to be considered in determining whether or not there is a resettlement.

CGT event E2 is the event that will usually apply in the case of a trust cloning where an asset is vested by the trustee to the trustee of an existing trust. There was a similar exception to that applying to CGT event E1 up until 31 October 2008, preventing a capital gain or loss from arising when:

> "… you transferred the asset from another trust and the beneficiaries and terms of both trusts are the same."[26]

It is anticipated that the exception announced in the 2009 Budget for fixed trust cloning will be similar to the exceptions from CGT events E1 and E2. What is unclear at present is what will, for the purposes of the new cloning exception, be a fixed trust.

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[24] This is confirmed as the ATO view when both CGT events A1 and E2 might apply – see Taxation Determination TD 2004/14
[25] ss105-55(5)(b) ITAA1997
[26] ss104-60(5)(b) ITAA1997

4.4 Income tax issues

There are a number of income tax issues to be considered when cloning or splitting a trust.

In analysing the income tax issues that arise from splitting or cloning it needs to be remembered that tax law proceeds from the position that a trust is a notional entity for tax purposes. In the case of a cloning there will be two 'trusts' after the cloning is complete and the income tax matters are relatively straight forward. It is more complex is where a trust is split as it is not clear under tax law whether for income tax purposes there is one trust or two trusts. There appears to be disagreement within the Sydney tax community as to whether there would be one trust or two after a split.

4.4.1 Interest deductions

Interest on borrowings will be deductible where the funds were borrowed for an income producing purpose and also where the borrowed funds were applied towards an income producing purpose. In addition interest on borrowings can continue to be deductible after an asset that was acquired with the borrowed funds is disposed of, as long as the nexus with the derivation of income has not been severed[27].

Where a trust cloning occurs and the asset that was acquired using borrowed funds is vested into the cloned trust or sold for no consideration, it is likely that the connection between the borrowed funds and the income producing use towards which they had been put would be severed, resulting in a denial of the interest deduction.

In the case of a splitting the analysis proceeds from the decision as to whether there is one trust or two. In the case where there is one trust interest would continue to be deductible. In the case where there are two trusts it would appear open to the trustees to determine between them who would be responsible for the servicing of any debt, and it would likely be necessary for the trustee servicing the debt to take possession of the asset acquired with the debt to prevent the connection with the derivation of assessable income from being severed.

4.4.2 Losses

Under tax law, your ability to claim a trust loss, disregarding for a moment the trust loss measures, relies on you being the entity that incurred the loss. On the cloning of a trust the trustee, the "you" that incurred the loss will still exist. There does not appear to be any barrier to this trustee claiming the loss even though it may no longer own the property that gave rise to the loss. In this instance the losses should continue to be available.

In the case of a splitting again the analysis proceeds from the decision whether to view the trust as one trust or two. In the case of there being one trust the losses would be available, subject to the standard trust loss tests. In the case where there are two trusts, it would appear best to allow the trust that takes the assets that generated the losses to utilise the losses, subject to the trust loss tests. Where the losses are not traceable to any particular assets in the absence of any other method it may be open to the trustees to agree as to how to deal with the losses between them.

4.4.3 Income tax returns

In the case of a cloning the new trust will be required to lodge a tax return and will be entitled to its own tax file number.

[27] see Federal Commissioner of Taxation v. Brown 99 ATC 4600 and Commissioner of Taxation v. Jones 2002 ATC 4135

In the case of a cloning, even if the view is taken that there is one trust, it appears on the face of it that the new trustee will be entitled to a separate tax file number.

Subsection 161(1) of the 1936 Act requires every *'person'* to lodge a return of income when required to do so by the Commissioner. A *'person'* is defined to include *'a person in the capacity of trustee of a trust estate'.* This appears to require/allow each trustee to lodge a return of income in respect of the income derived from assets it holds in relation to the trust.

Section 202B of the 1936 Act provides that a *'person'* may apply to the Commissioner for issue of a tax file number. Based on the definition of *'person'* each trustee appears to be entitled to apply. If the Commissioner is satisfied that the person's identity has been established the Commissioner *'shall issue'* a tax file number to the applicant subject only to:

- the Commissioner being satisfied that the person already has a tax file number;
- there not being an interim notice.[28]

It would appear that it is mandatory for the Commissioner to issue a tax file number if satisfied as to the applicant's identity. The exceptions should not apply. The legislation would appear to allow the separate trustee to obtain its own tax file number in respect of its role as trustee of the trust.

4.4.4 Family trust elections

In the case of a cloning the original trust, if it has made a family trust election, will still be subject to that election. Where assets are passed to the new trust care needs to be taken that there is no distribution outside of the family group.

The relationship between the two trustees and the trust assets remains the one trust estate on one view. If the trustee of the trust has made a family trust election that should continue to be effective notwithstanding the fact that an additional trustee has been appointed. The ramifications of having made a family trust election (or interposed entity election) flow from actions taken by the trustee of the trust from time to time notwithstanding the fact that the trustee is not the same person as the trustee that made the election.

In the alternative, if there are seen to be two trusts after a split then the position would be the same as for a cloning, with care needing to be taken that the new trust is part of the original family group.

4.5 Other issues

There are two other issues to be mentioned in connection with trust splitting and cloning.

4.5.1 Asset protection

In the case of cloning or splitting it will be important to understand the level of asset protection afforded. In some cases creditors of a trustee may be entitled to make a claim against assets held by a new trustee, for instance where there is security they hold over the asset concerned, where a transfer has occurred in frustration of their security, or where the trustee's lien gives the creditors an ability to make a claim against the assets. The legal issues involved in ensuring that the asset protection benefits of splitting or cloning are maximised is outside the scope of this paper. These issues are amply addressed in the paper by Mr Ken Schurgott referred to above.

[28] section 202BA 1936 Act

4.5.2 GST registration

In the case of a cloning it is clear that the new trust will be able to register for GST in its own right.

In the case of a splitting, whether separate GST registrations will be permitted will depend upon the view of whether there are two trust relationships or one. An entity is entitled to register for GST. An 'entity' includes a 'trust'. The trustee of a trust is taken to be an entity consisting of the person who is the trustee, or the persons who are the trustees, at any given time. An entity carrying on an enterprise that meets the registration turnover is required to be registered.